STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	:	
	:	**Docket No. 12-0511**
Proposed general increase in rates for gas distribution service	:	
	:	**(cons.)**
The Peoples Gas Light and Coke Company	:	
	:	**Docket No. 12-0512**
Proposed general increase in rates for gas distribution service	:	

INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Table of Contents

Page

STATE OF ILLINOIS
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North Shore Gas Company **Proposed general increase in rates for gas distribution service**	:	**Docket No. 12-0511**
	:	**(cons.)**
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STAFF OF THE ILLINOIS COMMERCE COMMISSION

Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission's ("Commission"), respectfully submits its Initial Brief in the above-captioned matter.

I. INTRODUCTION

A. Overview/Summary

North Shore Gas Company ("North Shore" or "NS") and the Peoples Gas Light and Coke Company ("Peoples Gas" or "PGL") (individually, the "Company" and collectively the "Companies", "Utilities", or "NS-PGL") filed new tariff sheets on July 31, 2012 in which the Companies proposed general increase in their natural gas rates. On September 6, 2012 the Companies' tariff sheets were suspended by the Commission and on December 19, 2012 the Commission entered a Re-suspension Order extending the suspension to and including June 27, 2013. In due course, the Administrative Law Judges ("ALJs") assigned to this proceeding established a schedule for the submission of pre-filed testimony, hearings and briefs. (*Tr.*, September 24, 2012, pp. 8-9)

In response to the Company's filing, the following parties filed Petitions to Intervene, which were granted: The People of the State of Illinois *ex rel.* Lisa Madigan, Attorney General of the State of Illinois (the "AG"); Citizens Utility Board ("CUB"); the City of Chicago ("City"); Interstate Gas Supply of Illinois ("IGS") and Local Union No. 18007, Utility Workers Union Workers of America, AFL-CIO ("UWUA Local 18007").

The following witnesses submitted testimony on behalf of Staff: Dianna Hathhorn (Staff Exhibit ("Ex.") 1.0 and Staff Ex. 11.0), Daniel G. Kahle (Staff Ex. 2.0, Staff Ex. 12.0, Staff Ex. 23.0 and Staff Ex. 24.0); Mike Ostrander (Staff Ex. 3.0, Staff Ex. 10.0, Staff Ex. 13.0 and Staff Ex. 25.0); Bonita Pearce (Staff Ex. 4.0 and Staff Ex. 14.0); Michael McNally (Staff Ex. 5.0 and Staff Ex. 15.0); Brett Seagle (Staff Ex. 6.0 and Staff Ex. 16.0); Christopher Boggs (Staff Ex. 7.0); William R. Johnson (Staff Ex. 8.0 and Staff Ex. 17.0); Alicia Allen (Staff Ex. 9.0); David Rearden (Staff Ex. 18.0); Darin Burk (Staff Ex. 19.0) Philliph Roy Buxton (Staff Ex. 20.0); David Sackett (Staff Ex. 21.0); and Rochelle Phipps (Staff Ex. 22.0).

During the course of the proceeding, Staff proposed various adjustments and changes to the Companies' July 31, 2012 request. The Companies accepted certain of Staff's modifications, and Staff withdrew others. A summary of Staff's final recommendations to the Commission in this proceeding for North Shore and Peoples Gas are attached hereto, respectively, as Appendix A and Appendix B. Also, attached as part of Appendix A and Appendix B are Staff's revised Revenue Requirements. For the reasons stated below, Staff's proposed adjustments should be adopted by the Commission.

II. TEST YEAR (Uncontested)

The Companies propose using their forecasted calendar year 2013 as the test year in this proceeding. (NS Ex. 5.0, p. 1; PGL Ex. 5.0, p. 1)

III. REVENUE REQUIREMENT

The revenue requirement schedules attached to Staff's Initial Brief use the Companies' surrebuttal revenue requirements as their starting point. To the extent that Staff's proposed adjustments were rejected or only partially accepted by the Companies and reflected in the Companies surrebuttal revenue requirement, Staff's proposed adjustments are shown either in total or in part as an adjustment to the Companies' surrebuttal revenue requirement. Staff's proposed adjustments that were accepted in total by the Companies and therefore are reflected in the Companies' surrebuttal position are not shown as an adjustment on Staff's Initial Brief Revenue requirement schedules.

A. North Shore

Staff recommends a revenue requirement of $81,089,000 as reflected on page 1 of Appendix A to Staff's Initial Brief.

Staff recommends an increase to base rates of $3,346,000 and an increase of $39,000 to other revenues for a total increase of $3,385,000 (4.36%).

Staff's overall recommended increase is $6,224,000 less than the $9,609,000 increase requested by the Company in surrebuttal.

B. Peoples Gas

Staff recommends a revenue requirement of $564,228,000 as reflected on page 1 of Appendix B to Staff's Initial Brief.

Staff recommends an increase to base rates of $16,135,000 and an increase of $809,000 to other revenues for a total increase of $16,944,000 (3.10%).

Staff's overall recommended increase is $80,861,000 less than the $97,805,000 increase requested by the Company in surrebuttal.

IV. RATE BASE

A. Overview/Summary/Totals

1. North Shore

Staff recommends a rate base of $195,783,000 as reflected on page 5 of Appendix A to Staff's Initial Brief. Staff's recommendation is $13,333,000 less than the $209,116,000 rate base requested by the Company in surrebuttal.

2. Peoples Gas

Staff recommends a rate base of $1,319,990,000 as reflected on page 5 of Appendix B to Staff's Initial Brief. Staff's recommendation is $339,281,000 less than the $1,659,271,000 rate base requested by the Company in surrebuttal.

B. Potentially Uncontested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

1. Cushion Gas Calculation

Staff witness Mr. Brett Seagle found that Peoples Gas originally overstated its requested utility plant in service with respect to its cushion gas calculation by $679,000 and $772,000 for years 2012 and 2013, respectively. (Staff Ex. 6.0, pp. 29-30) PGL witness Mr. Thomas Puracchio agreed that the Company intends to use a 3.0% cushion gas rate calculation instead of the 3.5% cushion gas rate calculation the Company included in its initial filing. (PGL Ex. 15.0, p. 8) Peoples Gas agreed to Staff's adjustment. (*Id*.)

2. Plant

a. Forecasted Test Year Capital Additions – Utility Plant in Service (PGL)

b. Advanced Metering Infrastructure Project

Staff witness Seagle recommended that the Commission remove Peoples Gas' requested addition of $3,800,000 associated with the advanced metering infrastructure project. (Staff Ex. 6.0, p. 19) NS-PGL witness Mr. Kyle Hoops provided additional information to support Peoples Gas' request. (NS-PGL Ex. 28.0, pp. 8-9) The additional information provided by Peoples Gas alleviated Mr. Seagle's concerns regarding the project, and Staff withdrew its adjustment. (Staff Ex. 16.0, pp. 6-7)

c. LNG Control System Upgrade and Related Project (PGL)

Staff witness Seagle recommended that the Commission remove Peoples Gas' requested addition of $5,146,000 associated with the LNG control system upgrade. (Staff Ex. 6.0, p. 24) PGL witness Puracchio testified that Peoples Gas was withdrawing this project from the current rate case. (NS-PGL Ex. 35.0, p. 2)

d. Calumet System Upgrade (PGL)

Staff witness Seagle recommended that the Commission remove Peoples Gas' requested addition of $50,000,000 in 2013 associated with this project. (Staff Ex. 16.0,

p. 11) NS-PGL witness Hoops provided additional information supporting the project, including an updated business case and revised cost data showing the project would cost $38,285,500. (NS-PGL Ex. 44.3, NS-PGL Ex. 44.0, pp. 8-9) Mr. Seagle agreed that the additional information provided by Peoples Gas sufficiently supported the project and recommended allowing the additional $38,285,500 into base rates. (NS-PGL Cross Ex. 13)

e. CNG Fueling Station (PGL)

In his direct testimony, Staff witness Mr. Brett Seagle testified that "Peoples Gas failed to provide sufficient information to demonstrate that the costs associated with the construction of the new CNG fueling station will be prudently incurred and the investment will be in service and used and useful." (Staff Ex. 6.0, p. 32) Thus, he recommended that the Commission remove from Peoples Gas' rate base $858,000 associated with the Peoples Gas CNG station at 1241 Division Street for the 2013 test year. Mr. Seagle found that Peoples Gas had conducted no initial review, due diligence or cost benefit analysis to determine if the project was needed or would benefit ratepayers. (*Id*., pp. 31-32) Furthermore, Mr. Seagle determined that Peoples Gas awarded this contract to a company that became an affiliate the day *after* it signed the contract to construct the CNG station. (*Id*., p. 33) By signing the contract in this manner, the Company effectively circumvented the law requiring Commission approval of contracts with affiliates. (Staff Ex. 21.0, p. 20)

The Companies' witness Mr. Hoops asserted that the "project is prudently undertaken, is reasonable in cost, and will be used and useful in providing utility service." Furthermore, Mr. Hoops indicated that the "project was competitively bid."

Next, Mr. Hoops provided evidence that CNG vehicles are cheaper for the company to fuel. Finally, Mr. Hoops indicated that there were new quick-fill capabilities at the CNG station as a result of the project. (NS-PGL Ex. 28.0 Rev., p. 11)

Staff witness Mr. Seagle testified that the evidence provided by Peoples Gas was not evaluated by Peoples Gas before the construction project was initiated.

> Peoples Gas failed to demonstrate this increased capacity was necessary or why its existing system was inadequate for its needs. In fact, it appears that Peoples Gas initiated this project without knowledge of any realized benefits for its customers…. Further, the Company's assumptions that increased use of CNG fuel 'benefits' customers both in reduced operational costs and environmental 'benefits' and that businesses utilizing CNG vehicles, or planning to use CNG vehicles 'benefit' from the availability of an additional CNG fueling station lack any detail demonstrating that the benefits associated with the project exceeded its costs. (Staff Ex. 16.0, p.17)
>
> …
>
> Peoples Gas must demonstrate a benefit to its customers or a need for a project in order to justify the prudence of its decision and in order for Staff to determine if the costs associated with the project will be prudently incurred. Further, if this is a "reasonable" business decision…, then this type of analysis would be available for Staff to review in order to determine the prudence of the project. However, Peoples Gas has failed to demonstrate a benefit or need for the project. (*Id*., p. 18)

Finally, Mr. Seagle testified that the public portion of the station was losing money each month. Thus, Peoples Gas never quantified the benefits to the customers from expanded capabilities and compared them to the costs of the project. (*Id*., pp. 13-19)

Staff witness Mr. David Sackett testified that the project was not reasonable in cost because Peoples Gas did not conduct sufficient *ex ante* analysis of economic-benefit, Peoples Gas did not conduct a robust Request For Proposals ("RFP") and contract management was not low-cost. Mr. Sackett supported his conclusion that the RFP was not robust because RFP dispersion was not sufficiently broad and bid selection was not efficient. He also claimed that the RFP process for construction, operation and maintenance had fundamental flaws. (Staff Ex. 21.0, p. 7)

Mr. Sackett testified that the lack of *ex ante* analysis indicates unreasonableness of the resulting decisions. Mr. Sackett considered it unreasonable for Peoples Gas to undertake construction projects where the expected costs from the project *exceed* the expected benefits. He also considered it unreasonable for Peoples Gas to fail to do any comparison of expected costs with expected benefits. He concluded that "Peoples Gas' failure to conduct any demand / market analysis regarding the station is not the action of a competitive firm in a competitive market. Rather these are the actions of a regulated monopolist delving into an unregulated market." (*Id*.)

Mr. Sackett demonstrated that the analysis of the benefits of CNG vehicles conducted by Peoples Gas was *ex post facto* and never included the cost of the vehicles or the infrastructure costs required to expand the fleet. (*Id*., p. 9)

> [Mr. Hoops'] testimony…ignores two very key points. First, there is no mention or analysis of the price of the vehicles. Generally, CNG vehicles cost more than their standard gasoline counterparts. The higher vehicle cost reduces the life-cycle benefit of the vehicles. (Peoples Gas Response to Staff DR DAS-10.04) Second, in order to have adequate capacity to actually fuel the new vehicles, significant investment in the new compressor was required. (NS-PGL Ex. 26.0, pp. 11-12) Ex post facto analysis does not justify decisions made without such analysis.
> (*Id*.)

Mr. Sackett concluded that when both of these factors are included, the CNG station is not economically justified even on an *ex post facto* basis. "If the cost of the vehicle and the cost of the infrastructure are included, the internal time-fill field is economically detrimental or harmful to them. Thus, after much discovery and testimony, Peoples Gas still has not provided any credible basis for its decision to construct the station." (*Id*., p. 12)

Mr. Sackett provided as evidence of the lack of due diligence the fact that Peoples Gas failed to take note that because the facility does not have a restroom and attendant on duty during operating hours, the City of Chicago would not allow Peoples Gas to sell CNG to any third-party other than by contract, until almost three months *after* construction was underway. (*Id*., p. 13)

While Peoples Gas witness Mr. Hoops referred to the project as "competitively bid," because they received more than one bid, Mr. Sackett's testimony shows that Peoples Gas only sent the RFP to three firms, two of which were in negotiations for acquisition by Integrys. The list of bidders was created by four employees, two of which left to work for the winning bidder. (*Id*., pp. 16-17) Mr. Sackett reached the following conclusion.

> The Commission should consider the full set of facts including the fact that Peoples Gas arbitrarily created the bid list which only contained three firms, only one company not in the process of being acquired by Integrys, and the fact that there was a conflict of interest that the bid list group had in determining the bid list. Peoples Gas' decisions had the effect of stacking the deck for Pinnacle by removing competitive forces *before* sending the RFP out. (*Id*., p. 17)

Mr. Hoops stated Peoples Gas rejected the bid of the non-affiliated firm because it was incomplete. However, Mr. Sackett provided evidence that the firm that was rejected did not provide the operational services included in the RFP. By adding an operational component to the RFP, Peoples Gas ensured that its affiliate would be the firm that won the bid and would construct and operate the station. (*Id*., pp. 17-22)

> Competitive pressures on Pinnacle were removed by sending the RFPs to two soon-to-be affiliates and an independent company that did not provide

> all the required services. Even if it was unintentional, the RFP failed to provide a second bid that was complete. And the Company failed to conduct any research to find any other possible firms outside of those already known to Peoples Gas. It is worth noting that Peoples Gas had been considering this project for *more than two years* before it sent out its RFP. There was ample time for it to find other qualified firms. If Peoples Gas had really desired to find the best company for the least cost, it could have spent more time and effort on researching for qualified construction firms. (*Id*., p. 22)

Regarding the fact that contract management was not low-cost, Mr. Sackett testified that "all work performed under the contract, was performed by Pinnacle while it was an affiliate with Peoples Gas. Any cost overruns or change orders would have to be negotiated by both firms as affiliates." (*Id*., p. 24)

Based on the testimony of these two witnesses, Staff concluded that the project was not prudently incurred (Staff Ex. 16.0. p. 19), and in its surrebuttal testimony, the Companies witness Mr. Hoops indicated that, "[e]ven though it continues to disagree with Staff's adjustment, in order to narrow the issues, Peoples Gas no longer objects to the adjustment." (NS-PGL Ex. 44.0, p. 2)

f. Incentive Compensation – capitalized amounts disallowed in prior cases

Staff proposed adjustments to remove capitalized incentive compensation costs previously disallowed by the Commission. (Staff Ex. 3.0, p. 5; Schs. 3.02 N and P, p. 4) The Companies accepted Staff's adjustments in rebuttal testimony. (NS-PGL Ex. 26.0, p. 5)

g. Original Cost Determination as to Plant Balances as of December 31, 2011

Staff and the Companies agree that the Commission's Order should state the following with respect to the Original Cost Determination:

> It is further ordered that the $3,016,429,000 original cost of plant for Peoples Gas at December 31, 2011, reflected on Peoples Gas' NS-PGL Ex. 27.14P, Line 19, Column B, is unconditionally approved as the original cost of plant. It is also ordered that the $424,299,000 original cost of plant for North Shore at December 31, 2011, reflected on North Shore's NS-PGL Ex. 27.14N, Line 17, Column B, is unconditionally approved as the original cost of plant. (NS-PGL Ex. 27.0, p. 36)

(Staff Ex. 12.0 REV, p. 27)

3. Budget Plan Balances

4. Accumulated Deferred Income Taxes - 50/50 Sharing Related to Tax Accounting Method Change

Staff witness Ms. Bonita Pearce (Staff Ex. 4.0, Schs. 4.03 N and P), Intervenor witnesses Mr. David Effron (Ex. AG 2.1, Schs. DJE-1 N and P), and Mr. Ralph Smith (CUB-City Ex. 1.2, p. 12; CUB-City Ex. 1.3, p. 12) proposed to remove the 50% sharing of FIN 48 liability related to tax treatment of Overheads. The impact of these adjustments was to increase ADIT liability and to reduce rate base. The Companies withdrew their 50% sharing adjustments in the rebuttal testimony of witness John P. Stabile. (NS-PGL Ex. 30.0, pp. 16 – 17) Accordingly, these adjustments are no longer contested.

C. Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

1. Year End Rate Base or Average Rate Base

The Commission should adopt Staff's adjustments to compute rate base on an average methodology, since Staff's method takes into account that investments are made throughout the test year, rather than the Companies' method of a year-end rate base which inappropriately assumes, for rate setting purposes, that all investments are made at the beginning of the test year. (Staff Ex. 12.0R, Schs. 12.01 N and P Rev.) The Companies chose a future test year ending December 31, 2013. An average rate base derives rates that properly match test year revenues and expenses which will occur throughout 2013 with the level of rate base investment also occurring throughout the year. A year-end rate base would derive revenues and expenses for 2013 which represent a level of investment that would not exist until the end of 2013. (Staff Ex. 2.0, pp. 4-5)

A test year is a time period used to develop costs representative of the first year in which rates being set will be in effect. (*Id*., p. 4) Under the Commission's rules, utilities may select a historical test year or a future test year. (83 Ill Adm. Code 287.20) As far as Staff is aware, the Commission has only approved the use of a year-end rate base with a historical test year and has rejected proposals to use a year-end rate base with a future test year. (Staff Ex. 2.0, pp. 6 - 8) The Companies selected a future test year which is already forward looking in that it largely relies upon projected costs. (Staff Ex. 2.0, p. 4)

The Companies argue that a year-end rate base is necessary to provide for adequate recovery of plant investments made throughout a future test year. (NS-PGL

Ex. 27.0, p. 6) This flawed argument is based on the likely effective date of the tariffs rather than on the measurement of a test year's rate base. Staff's adjustments to compute rate base on an average methodology provide the proper rate base for the test year.

The Companies further argue that an increasing level of investments justifies the use of a year-end rate base. (PGL Ex. 7.0, p. 6; PGL Ex. 7.2; NS Ex. 7.0, p. 5 and NS Ex. 7.2) An increasing level of investments, however, is the norm rather than the exception. (Staff Ex. 2.0, pp. 10-11) Under cross examination, the Companies' witness Mr. James F. Schott admitted that one would usually expect continuing increases to plant investments and rate base following a test year. (*Tr*., February 6, 2013, pp. 405-406) Furthermore, the Commission has considered this argument in prior rate cases and found that an increasing level of investments did not justify the use of a year-end rate base with a future test year. (Staff Ex. 12.0, pp. 6-7) Should the Companies make additional significant investments beyond the future test year; however, the Companies can file new rate cases in order to recover the costs of projected investments occurring after the future test year. In fact, the Companies are already required to file biennial rate cases in 2014 and 2016 per Section 9-74 220(h-1) of the Public Utilities Act ("Act" or "PUA"). (Staff Ex. 12.0, p. 4) The Companies will, again, have the choice of the most appropriate test year for their investment levels in such rate filings. Further, the Companies have not addressed why an average rate base is appropriate for North Shore, since it does not have the significant plant investment needs of the Peoples Gas accelerated main replacement program. (*Id*.)

The Companies also argue that the likely effective date of the tariffs justifies the use of a year-end rate base. (PGL Ex. 1.0, p. 3; NS Ex. 1.0, p. 3; PGL 7.0, p. 4; NS 7.0, p. 4) The Companies, however, could have selected a future test year with an ending date as far out as July 31, 2014. Instead, the Companies chose a future test year ending December 31, 2013. Mr. Schott testified that, in making the decision to use a future test year ending December 31, 2013, the Companies did not make an estimate of the cost of preparing forecasts for a non-calendar year test period; did not quantify the monetary affect of using a calendar test year that would not align the test period and the period rates were in effect; and did not perform a cost benefit calculation to determine if preparing a test year that aligned with the period rates were in effect was worth the effort. (*Tr*., February 6, 2013, pp. 440-441) Company witness John Hengtgen testified that the test year chosen by the Companies is not representative of the time that rates will be in effect and that the representative test year is 2014. (*Tr*., February 7, 2013, pp. 592-593) Thus, the Companies' year-end rate base proposal appears to be an attempt to correct a poorly chosen test year with an improperly measured rate base. Any perceived disadvantage from this choice that the Companies alone made should not now be cause for the Commission to adopt an improperly measured rate base that is inconsistent with Commission practice. As Mr. Schott testified, the Commission does not ensure that a utility recover its costs based on the relation of the end of a test year and the date rates take effect. Further, as Mr. Schott testified, the Companies will not be denied recovery of plant investments in excess of the estimated average investment amounts included in rate base as the Companies may seek to have all such incremental investments included in rate base in future rate cases. (*Tr*., February 6, 2012, pp. 414-415)

Staff's position is consistent with recent rate cases in which the Commission approved an average rate base with a future test year: Docket No. 08-0363, Northern Illinois Gas Company (filed June 4, 2008); Docket No. 09-0319, Illinois-American Water Company, (filed July 8, 2009); Docket No. 11-0282, Ameren Illinois Company (filed March 23, 2011); Docket No. 11-0767, Illinois-American Water Company (filed December 7, 2011); Docket Nos. 11-0280/0281 (filed February 15, 2011) and Docket Nos. 09-0166/0167 (filed February 25, 2009). (Staff Ex. 2.0, p. 8) Docket Nos. 11-0280/0281 and Docket Nos. 09-0166/0167 are the Companies' most recent rate cases. Staff's position is also consistent with that of the AG and CUB-City who also propose that an average rate base be used in this proceeding. (AG Ex. 1.0, pp. 10-13; AG Ex. 2.0, pp. 4-8; CUB-City Ex. 1.0, pp. 13-17)

The Companies argue that "the facts of this case compared to that of the Utilities' last two rate cases certainly are different and therefore is [sic] relevant." (NS-PGL Ex. 43, p. 6) Again, these facts – the timing of the rate filing, effective date of new rates, and level of proposed investment – were known to the Companies and subject to their own decisions for the test year period. The Commission's practice with respect to average rate base for future test periods is well established, and the Companies have not demonstrated sufficient justification to break this long-standing precedent.

The Companies made a belated alternative proposal to use an "average" rate base as of September 30, 2013. Since this alternative proposal was introduced in the Companies' surrebuttal testimony, Staff has not had the opportunity to seriously consider or investigate this alternative proposal due to time constraints. The alternative proposal unsurprisingly results in a rate base amount that is closer to the Companies' year-end rate base proposal than the proper average rate base for the test year. No party has filed testimony in support of this alternative proposal, not even Mr. Hengtgen who offered the proposal. (*Tr*., February 7, 2013, p. 587) This late offered alternative has not been properly vetted in this proceeding and should not be seriously considered as a valid option.

2. Plant

a. Forecasted Test Year Capital Additions – Utility Plant in Service (NS)

The Commission should reduce North Shore's forecasted test year capital additions to reflect a level that is likely to be spent based on the Company's historical spending pattern. The reduction is necessary to reflect the Company's inability or unwillingness to incorporate into its forecast an allowance for unforeseen changes that history has shown to result in less actual capital expenditures than budgeted. (Staff Ex. 12.0, p. 13; Staff Ex. 24.0, Sch. 24.02N)

The Company avers that projects are rescheduled or delayed due to factors beyond its control. (NS-PGL Ex. 28.0, pp. 3-5) The Company further contends that its historical-based forecasting is accurate allowing for unforeseen external changes. (NS-PGL Ex. 28.0, p. 1) Rescheduled public improvement projects may be outside of North Shore's control, but that is irrelevant. An allowance for unforeseen external changes based on the Company's experience should be included in the development of its forecasts. The Company's argument merely demonstrates the well known fact that there is uncertainty and inaccuracy inherent in forecasting and budgeting for capital expenditures. The Company does not suggest that unforeseen events will not occur in the test year. Staff's proposal would adjust the Company's rate base to account for unforeseen changes based on a three-year average variance between the Company's actual and budgeted capital expenditure amounts.

The Company also takes issue with the use of the three-year average Staff uses to prepare an analysis of planned and actual spending. However, the recent three-year period best represents the Company's' current operations and provides a suitable basis on which to predict the Company's future capital spending. Staff witness Kahle used a three-year period for this type of analysis in two recent rate cases: Docket No. 09-0319 – IAWC and Docket Nos. 11-0280/0281 – the Companies' last rate proceeding. Both IAWC and the Companies accepted Staff's proposed adjustments. IAWC accepted Staff's adjustments for the purpose of that rate case. The Companies accepted Staff's adjustments in order to narrow the number of contested issues. (Staff Ex. 12.0, pp. 15-16)

b. Accelerated Main Replacement Program Projects (PGL)

i. Section 8-102 Investigation of AMRP

Given the uncertainty surrounding Peoples' Accelerated Main Replacement Program ("AMRP") and the Company's ability to complete the AMRP successfully, the Commission should conduct an investigation of the AMRP under Section 8-102 of the Act (220 ILCS 5/8-102), regardless of whether it accepts Staff witness Seagle's AMRP adjustment, which it should. (Staff Ex. 20.0, p. 23) Such an investigation will ensure that Peoples will complete its AMRP on a going forward basis at a reasonable cost and within a reasonable time. (*Id.,* p. 25) In his testimony, Staff witness Roy Buxton described the scope and nature of an appropriate investigation, including a verification phase and future rate case testimony. (*Id.*, pp. 3-9) The investigation will cost an estimated $2.5 million; however, given the significant cost of the AMRP to date, the cost of the investigation is justified. (*Id.*, pp. 27-28) While Peoples will initially bear the cost of the investigation, the utility can eventually recover the cost from ratepayers through the normal ratemaking process. (*Id.*, pp. 28-29)

Peoples Gas proposed its AMRP four years ago in its February 25, 2009 filing in Docket No. 09-0167; however, since then, the AMRP has fallen behind schedule, while consuming its budget on what little work it has completed. (*Id*., pp. 8-9) The AMRP encountered problems with scheduling, materials delivery, government permits, and underground utility locating. (*See* Staff Ex. 20.0, Attach 20.01) Peoples Gas has given the Commission no reason to believe that it can complete the AMRP in 20 years, and no evidence for the total cost of the eventually completed AMRP. Further, and more troubling, there is no evidence that Peoples Gas can solve its AMRP problems. (*Id.*, pp. 8-9) Staff witness Brett Seagle's recommended adjustments to the capital cost of the AMRP discussed below provide further support for Staff's recommendation that the Commission examine the program as outlined in Mr. Buxton's testimony.

It is clear that AMRP is a matter of significant public interest for both Peoples Gas and its ratepayers. In Docket No. 09-0167, Staff witness Harry Stoller explained his understanding of the condition of Peoples Gas' mains and the need for a gas main replacement program.

> While others might disagree with my characterization of Peoples Gas' distribution system, the Marano testimony leads me to conclude that it is old, it is antiquated, and it is approaching the point that further aging and deterioration will eventually cause replacement to maintain public safety to become an emergency matter rather than one which can be reasonably planned and executed. Whether or not the twenty-year replacement program Mr. Marano has advocated will get the job done soon enough is probably anybody's guess. What I am convinced of is that Peoples Gas should begin the replacement program very soon to avoid the possibility of a later emergency situation. (Docket No. 09-0167, ICC Staff Ex. 14.0, p. 6, lines 142-149)
>
> (*Id*. p. 12)

Staff witness Buxton continues to agree with that assessment.

The Commission declared its support for the AMRP in its Order in that same docket, where the Commission made the following statements among others:

> In other words, while the Commission would surely initiate a Section 8-503 proceeding on the basis of Staff's account if it were faced with Company obstinacy or disregard . . .
>
> With Staff's testimony, <u>accelerated system improvement has become for the Commission a matter of the public interest more so than just a Company proposa</u>l. (Final Order, Docket No. 09-0167, January 21, 2010, p. 194)
>
> (*Id.,* p. 13)(Emphasis added)

Four years after Peoples proposed the AMRP, Peoples Gas should have the AMRP well underway. Four years is 20 percent of a 20-year AMRP schedule. (*Id.)* However, Peoples is still experiencing considerable problems. It has completed only 95 percent of the AMRP work it planned for 2011, less than 50 percent of the work it planned for 2012, and it has reduced the amount of work it plans to complete in 2013. (NS PGL Ex. 21.1, p. 1) While Peoples Gas points to the amount of main replacement that occurred during 2011, 2012 and 2013, (NS PGL Ex. 49.0, pp. 6-8, *Tr*., February 5, 2013, pp. 339-

345), Staff notes that the total amount is irrelevant if the amount projected and budgeted for is not accomplished, as this is the amount Peoples Gas seeks to recover from ratepayers. Ratepayers should not bear the burden of Peoples Gas' delays in the AMRP and should only be required to pay for what Peoples Gas has accomplished. The Company was not ready to begin the AMRP when it made its filing in Docket No. 09-0167, and it is Staff's opinion that Peoples Gas is not ready now. (Staff Ex. 20.0, pp. 17-18)

The Commission apparently assumed in its Final Order in Docket No. 09-0167 that Peoples Gas possessed a significant level of ability to perform gas main work in Chicago. (Order, Docket No. 09-0167, January 21, 2010, p. 195) However, an examination of information in the record in this proceeding tells a different story. The Company did not expect and took no advanced actions to prevent its greatly increased construction pace to overwhelm the City of Chicago's Office of Underground Coordination. (*See* Staff Ex. 20.0, p. 15 and Attach 20.01) Peoples Gas failed to expect and plan for the Chicago Department of Transportation having difficulty keeping up with Peoples' accelerated pace asking for construction permits. Peoples Gas failed to anticipate and plan for Digger (the underground locating service for the City of Chicago) not being able to keep pace with Peoples Gas' much higher volume of requests to mark utility locations in the field. Additionally, Peoples Gas allowed too little lead time for delivery of construction materials. (Staff Ex. 20.0, pp. 14-16) According to the Company's own witness, Peoples Gas is in a position where it will spend additional dollars at the same time it will accomplish less volume of work. (NS PGL Ex. 21.0, p. 1)

Peoples Gas claims to have a 20-year plan for the AMRP, but the plan is not sufficiently detailed. There is no budget in the plan. The plan does not even mention costs. (*Id.*, p. 19) According to Peoples Gas witness Mr. Phillip M. Hayes, Peoples Gas' senior management tells its staff how much money it can spend each year on the AMRP, then the staff determines which gas mains it should replace first and how many mains it can replace with the funds that senior management has made available. (*Id.*, p. 18) That is not long-term planning. Under these conditions, without a plan, Peoples Gas will be unable to perform the AMRP with any efficiency or effectiveness. Neither the Commission nor any other interested party will have any measure of the Company's adherence to a schedule because there is no schedule. Likewise, the Commission cannot know whether Peoples Gas is experiencing cost overruns because there are no cost estimates. (*Id.*, pp. 19-20)

The cost of Staff's recommended investigation of AMRP is difficult to predict, but an estimate of the cost of the investigation less the cost of providing the investigation results in future rate cases is approximately $2.5 million dollars. (*Id.*, p. 27) This estimate includes the cost of a one-year investigation phase resulting in recommendations and a two-year verification phase where the consultant checks Peoples Gas' work for implementing the recommendations from the investigation phase. (*Id.*, pp. 27-28)

While one of the goals of regulation is for utilities to provide safe and reliable service (220 ILCS 5/1-102), there is also the goal, among others, that utilities are to provide least cost public utility service. (*Id.*) Accordingly, with respect to the goal of least cost service, only the cost of prudent and used and useful AMRP construction can be included in rate base and recovered from ratepayers. (220 ILCS 5/9-211) Consistent with the first goal of safe and reliable service, the Commission has already acknowledged the importance of the AMRP for safe gas service and the urgency to complete the project in 20 years. No party should dispute that the AMRP should move forward as quickly and efficiently as possible. This is not possible given Peoples Gas' failure to provide evidence of real AMRP plans or budgets and given that the utility has proven that it cannot meet its intended construction goals in 2011, 2012, or 2013. Staff's recommendation to reduce Peoples Gas' AMRP related gas rate base by almost $219 million[1] discussed below, which is consistent with the second goal of least cost service, demonstrates that careful attention must be paid to Peoples Gas' AMRP on a going forward basis through an investigation as recommended by Staff witness Buxton. This Section 8-102 investigation is essential to assuring that this massive project of significant public interest continues forward in a manner that does not waste large amounts of ratepayer money simply due to mismanagement. Therefore, to assure that the AMRP moves forward in the most expedient, cost-effective manner, the Commission should adopt Staff's recommended investigation of Peoples Gas' AMRP.

ii. AMRP Adjustment

Staff witness Seagle recommended that the Commission exclude certain costs associated with Peoples Gas' AMRP from its base rates. Specifically, Mr. Seagle recommended that the Commission remove $95,794,000 in 2012 and $122,804,000 in 2013 from Peoples Gas' requested ARMP costs. (Staff Ex. 16.0, p. 22)

[1] $95,794,000 disallowance for 2012 AMRP construction plus $ 122,804,000 disallowance for 2013 AMRP construction equals a total disallowance of $218,598,000. ICC Staff Ex. 16.0, p. 26.

Mr. Seagle testified about two concerns regarding the manner that Peoples Gas pursued this project. First, Peoples Gas lacks appropriate methodology to plan and track the project. Second, Peoples Gas' projection of work completed for 2012 and 2013 missed its estimate by a factor of almost two. (Staff Ex. 6.0, p. 39) Based on these concerns, Mr. Seagle proposes disallowing a portion of the costs that Peoples Gas claimed it would incur. Mr. Seagle based his calculation on a comparison of the amount of actual work completed versus the amount of work Peoples Gas projected it would complete in 2012 and 2013.

Construction Methodology

Mr. Seagle testified that Peoples Gas' methodology for how it developed its AMRP schedule lacks any reasonable policies and/or procedures to provide guidance for its Engineering and Operations personnel to develop a workable schedule. (Staff Ex. 16.0, p. 23) Staff noted that this type of information is necessary for the Company to establish the project milestones that it uses in the bidding process. (*Id.*) Of particular concern is that Peoples Gas appears to leave the actual planning of construction work to the discretion of the contractor performing the work at street level. Mr. Seagle stated that this type of planning is inadequate because no policies or procedures were in place before the meetings were held between engineering personnel, operations personnel, construction managers, and contractors. (*Id*.) Further, Mr. Seagle found that the lack of adequate planning by Peoples Gas' management is likely a factor causing Peoples Gas to not complete its planned or forecasted AMRP construction and restoration work within the time allotted.

Peoples Gas disputes Mr. Seagle's recommendation. In particular, Peoples Gas attempts to demonstrate that the development of the AMRP schedule is "best practice." (NS-PGL Ex. 49.0, p. 24) Peoples Gas states that the construction installation schedule is left to the contractors' discretion. (*Id*.) In fact, Company witness Mr. Philip Hayes states: "To get a more detailed schedule developed, best practice has the installation contractor in turn develop a block by block approach as to when the work is planned as they are the ones supplying and directly overseeing the contractors labor and equipment resources." (*Id.*) Staff disagrees with Mr. Hayes contention.

Staff's review reveals that Peoples Gas' "best practices" are inadequate given the poor progress that Peoples Gas has made on this project compared with its projections. (Staff Ex. 6.0, p. 39) Indeed, Peoples Gas witness Hayes explains that Peoples Gas has not yet completed all of the <u>2011</u> AMRP distribution projects. Mr. Hayes states that approximately 95% of the 2011 AMRP distribution projects are completed, leaving approximately 5% of the 2011 AMRP distribution projects unfinished. (NS-PGL Ex. 34.0, p. 10) Further, Peoples Gas provided no documentation demonstrating it used sound procedures or policies in association with its ARMP project. Instead, Peoples Gas provided vague generalizations of how it intends to provide guidance to contractors, so that the contractors can develop an actual plan directly before the contractor begins construction at that particular street or block. (Staff Ex. 16.0, pp. 24-25)

Aside from the inadequate "oversight" of its contractors, Peoples Gas also lacks a means to track the project sufficiently. Peoples Gas provided an AMRP Weekly Report, Summary Status (NS-PGL Ex. 34.3) that shows the percentage of completion of the 2011 and 2012 AMRP distribution projects, as well as the Accelerated Six Distribution Projects and the High Pressure Main Installation Project. Peoples Gas claims these documents demonstrate that it is making better progress towards AMRP construction and restoration goals compared to the current rate of completion of AMRP construction goals. However, this document does not provide any detail regarding plans, discussions, or meetings held to address issues with regard to meeting AMRP construction and restoration goals. Without this detail, the Commission and Staff are unable to determine if Peoples Gas is making better progress towards AMRP construction and restoration goals compared to the current rate of completion of AMRP construction and restoration goals. (Staff Ex. 16.0, p. 25)

Based on the information detailed above, Mr. Seagle determined that the methodology applied to develop Peoples Gas' AMRP schedule lacks any reasonable policies and/or procedures to provide guidance for its Engineering and Operations personnel in developing a workable schedule. Therefore, Staff recommends that the Commission accept Mr. Seagle's position that Peoples Gas' actions were imprudent, and exclude the portion of Peoples Gas' costs associated with the AMRP from its rate base.

Work Completed

Mr. Seagle testified that Peoples Gas failed to complete the level of planned AMRP construction and restoration work that Peoples Gas claimed it would conduct in 2012 and 2013. (Staff Ex. 6.0, p. 39) Mr. Seagle's comparison of planned AMRP work to actual AMRP work completed showed that Peoples Gas' contractors were well behind the planned or forecasted schedule, which Peoples Gas utilized in its cost projections for the project. (*Id*.) Mr. Seagle found that Peoples Gas only finished about *half* of the AMRP work it planned to complete, but incurred approximately the same capital costs. In other words, the project costs per mile were almost *double* Peoples Gas' projections. (*Id*., pp. 39-40) Peoples Gas projected it would install 165 miles of gas main in both 2012 and 2013, but Peoples only met 53% of its goal in 2012 and has now revised its forecasted miles in 2013 to approximately 50% of its original projections. (Staff Ex. 6.1, Sch. 6.1 P) Further, as noted earlier, Peoples Gas still has 5% of its 2011 work yet to complete. (NS-PGL Ex. 34.0, p. 10)

Peoples Gas' lack of progress on this project is a result of its reliance on inaccurate assumptions. (Staff Ex. 6.0, p. 41) Peoples Gas noted stated that it had yet to complete a full year of the program where the Company could collect the full cost and resource data, and then be able to accurately forecast for future years. (*Id*.) Staff does not dispute that Peoples lacked a full year of activity; however, Peoples Gas should have unequaled expertise in every aspect of planning, designing, constructing, maintaining, and replacing underground gas mains in Chicago. With 150 years experience digging up Chicago streets, the Company should have a solid understanding of just how much funding it will expend on each type of construction project and should have taken preemptive action to mitigate budget and scheduling complications. Staff's review of the record indicates that no mitigation took place. (Staff Ex. 20.0, pp. 4-6)

Peoples Gas' use of inaccurate assumptions coupled with its inability to achieve any reasonable percentage levels of project completion, led Mr. Seagle to determine that Peoples Gas' failure was the result of its own lack of prudence in conducting the AMRP project.

Calculation of Adjustment

Mr. Seagle formed the basis for his adjustment by comparing the percentage completion rate for a number of categories that Peoples Gas tracked within its project. (Staff Ex. 6.0, pp. 37-38) In particular, Mr. Seagle's calculation relied on the number of miles of main installed, miles of main gassed, gas services installed, meters installed, and the miles of old main removed from service. (*Id*.)

Peoples Gas disputes the need for an adjustment, and articulated two criticisms of Mr. Seagle's calculation. First, Peoples Gas contends that Mr. Seagle did not include in the calculation of his adjustment the costs associated with the carry over work not completed in 2011. (NS-PGL Ex. 34.0, pp. 4-5) Mr. Seagle acknowledged this oversight and corrected his calculation to account for the carryover work. (Staff Ex. 16.0, p. 21)

Second, Peoples Gas stated that Mr. Seagle did not include all of the categories that it tracks in his calculation. (NS-PGL Ex. 34.0, pp. 4-6) Mr. Seagle explained that his calculation did not include the category labeled "Main – As Built "in the calculation because it was not clear what the category "Main – As Built" represents. (Staff Ex. 6.0, p. 38) Mr. Seagle also excluded two other categories from his calculation due the nature of those categories, "Contractor Interim Restoration" and "Contractor Final Restoration." (*Id.*) Mr. Seagle did not use these categories because having interim or final restoration in place would not affect whether or not Peoples Gas could activate or use the gas piping system, plus Peoples itself admitted that some of these topics are not representative of the level of work completed. (*Id.*; NS-PGL Ex. 34.0, p. 6)

For the reasons stated, Mr. Seagle continues to recommend that the Commission exclude from base rates the portion of costs associated with Peoples Gas' Accelerated Main Replacement Program. Specifically, Mr. Seagle recommends that the Commission remove $95,794,000 in 2012 and $122,804,000 in the 2013 of People Gas' requested rate base addition associated with the AMRP. (Staff Ex. 16.0, p. 22)

c. Construction Work in Progress (PGL)

AG witness David J. Effron recommends reducing Peoples Gas' Construction Work in Progress ("CWIP") to $4,639,000 to exclude AMRP projects that will not be used and useful in providing service in the 2013 test year. (AG Ex. 5.0, p. 13) Mr. Effron supports his concerns about the Company's completion of projects as planned (AG Ex. pp. 11-12). Correspondingly, Staff recommended a reduction of Peoples Gas' rate base due to the Company's inability to provide a reasonable project plan and failure to demonstrate that it will incur the AMRP costs it projected for the test year. (Staff Ex. 16.0, pp. 20-26) Mr. Effron's proposed adjustment may be duplicative of Staff's adjustment. (NS-PGL Ex. 43.0, p. 14) Since the level of duplication has not been established, the Commission should adopt Staff's adjustment rather than Mr. Effron's, but not both.

Additionally, Mr. Effron advocates for too strict a test to determine if CWIP should be included in rate base by using December 31, 2013 as the date by which CWIP must be placed in service. (AG Ex. p. 12) The Act allows the Commission to **include in the rate base of a public utility an amount for CWIP for a public utility's investment which is scheduled to be placed in service within 12 months of the date of the rate determination**. (220 ILCS 5/9-214(e) (Emphasis added)) Mr. Effron does not offer support of an amount of CWIP that will not be in service within 12 months of the date of the rate determination; which will be approximately July 2014. The Commission should not accept the amount of Mr. Effron's adjustment unless a finding is made that none of CWIP will be placed in service within 12 months of the date of the rate determination.

d. Non-Union Wages (see also Section V.C.2)

e. Capital Costs for Non-AMRP Gas Services

Not until the Company's surrebuttal did Peoples Gas witness Mr. Kyle Hoops request an increased amount for Non-AMRP gas services. Mr. Hoops claimed that Peoples Gas originally underestimated this amount and that Peoples Gas had only estimated $4,359,396 in Non-AMRP Gas Services for 2013. (NS-PGL Ex. 44.0, pp. 9-10) Mr. Hoops then claimed that Peoples Gas incurred $26.0 million, $18.5 million, and $24.5 million, respectively, in 2010, 2011 and 2012 for Non-AMRP Gas Services, or an average of $23.0 million. (*Id.*) He then claimed that the Commission should allow Peoples Gas to increase its requested amount for Non-AMRP Gas Services by the amount of the reduction in the costs associated with the Calumet System Upgrade or an increase from $4,359,396 to $16,073,896." (*Id.*)

Staff's position is that NS/PGL could have and should have offered testimony about these costs related to the Non-AMRP gas services when it filed Direct Testimony. In fact, Peoples Gas had two additional opportunities to find its claimed "error" because Peoples Gas also filed Supplemental Direct and Rebuttal Testimony. Instead, Peoples provides no rationale for why this “error” occurred and no excuse for why it did not discover the “error” sooner.

Furthermore, the Companies’ request took place when the parties of the proceeding had no time to investigate or respond to this change. As a result, NS-PGL’s submission of Mr. Hoops’ over $12 million increase in Non-ARMP Gas Services costs (NS-PGL Ex. 44.0, p. 10 and Staff Cross Ex. 11) prejudices the parties, because they were deprived of a meaningful opportunity to investigate and respond to Mr. Hoops’ testimony prior to the evidentiary hearing. Moreover, the timing of the request resulted in the parties being unable to review the request to ensure that it satisfies the Commission’s requirements for a capital addition, namely that the project meets the prudence and used and usefulness standards of the PUA. For these reasons, Staff recommends that the Commission reject Peoples Gas’ request for a last minute $12,122,000 rate base and $242,000 depreciation expense increase[2].

3. Cash Working Capital

a. Pass-Through Taxes

The Commission should not allow a revenue lag[3] for pass-through taxes. Pass-through taxes are not operating revenues and are not included in the revenue requirement as operating revenues. The Companies’ offered a proposal in their surrebuttal testimony to use zero lag days for pass-through taxes. (NS-PGL Ex. 43.0, p. 23, ll. 520-524) Staff accepted this proposal on cross examination. (*Tr*., February 4,

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[2] Staff Cross Ex. 11

[3] Lag times are associated with the collection of revenues owed to the Companies (that is, the collection of cash from customers’ lags behind the Companies’ cash outlays for the provision of service). (Staff Ex. 2.0, p. 13)

2013, pp. 151-152) The AG also recommends no revenue lag for pass-through taxes. (AG Ex. 1.0, pp. 52-54)

b. Pension/OPEB

The Commission should assign an expense lead[4] of negative 33.91 days for pension and OPEB expenses in North Shore's CWC calculation and negative 35.23 days for Peoples Gas. (Staff Ex. 2.0, p. 20)

Amounts included in rate base are items funded by investors on which the investors earn a return, while amounts included in CWC are expenses from the operating statement. Regardless of whether or not an amount for pensions or OPEB is included in rate base, both items also have an operating expense component in the revenue requirement. It is the operating expense component that generates the CWC lead that Staff proposes. Staff recommends that the expense leads for inter-company billings should be used for pension and OPEB expenses in the CWC calculation. The expense leads for inter-company billings were used by the Companies for calculating CWC for pensions and OPEB expenses in their most recent rate case. (Staff Ex. 2.0, pp. 20-21)

c. All Other

Staff agrees that the lead days for pass-through taxes should be the actual numbers of days that each pass-through tax is held as put forth in the Companies' rebuttal and surrebuttal testimony. (NS-PGL Ex. 27.0, pp. 18-21) (NS-PGL Ex. 43.0, p. 24, ln. 528-538) The lead days to be used are the following:

[4] Lead times are associated with the payments for goods and services received by the Companies (for example, vendors may allow the Companies to pay for goods and services after the goods and services were received). (*Id.*)

Pass-Through Tax	Lead Days–Peoples Gas	Lead Days–North Shore
Gross Receipts/Municipal Utility Tax (MUT)	(24.200)	(60.520)
Energy Assistance Charges (EAC)	(18.360)	(19.550)
Gas Revenue/Public Utility Tax (GRT)	10.630	9.440
City of Chicago Gas Use Tax (CITY GUT)	(24.310)	N/A
(North Shore and People's Gas Cross Exhibit No. 1)		

4. Retirement Benefits, Net

The Commission should accept Staff witness Pearce's (Staff Ex. 4.0, Schs. 4.01 N and P) and Intervenor witnesses Effron's (Ex. AG 2.1, Schs. DJE-1 N and P) and Smith's (CUB-City Ex. 1.2, p. 11; CUB-City Ex. 1.3, p. 11) proposed adjustments to remove the Companies' alleged "pension asset," net of related ADIT, from rate base for the reasons explained below. The Companies presented the alleged "pension asset" net of the OPEB liability on a single schedule identified as "Retirement Benefits, Net." Staff and Intervenors did not include the OPEB liability in their adjustments. Accordingly, those parties correctly left the OPEB liability unadjusted, as a reduction to rate base.

Peoples Gas argued in rebuttal (NS-PGL Ex. 31.0, p. 3) and surrebuttal (NS-PGL Ex. 47.0, p. 2) testimony that the Retirement Benefits, Net should remain in rate base, whether or not a year-end or average rate base methodology is approved by the Commission. Alternatively, the Companies propose that if the Peoples Gas' alleged pension asset is excluded from rate base, and North Shore Gas has a pension liability because the year-end methodology is used, the pension liability should also be excluded from rate base and not as a reduction to rate base. (NS-PGL Ex. 47.0, p. 2)

The alleged "pension asset" was created with funds supplied by ratepayers, not shareholders. Therefore, shareholders are not entitled to earn a return on it.

The Companies incorrectly allege that they have a "pension asset" that should be included in rate base. The argument should be rejected because the amount that the Companies allege to be a "pension asset" was not created with funds supplied by shareholders. Instead, they represent amounts from normal operating revenues collected or to be collected from utility rate payers. Under Illinois law, for ratemaking purposes, a public utility may not receive a return on investment from ratepayers for ratepayer-supplied funds. *City of Alton v. Illinois Commerce Commission,* 19 Ill. 2d 76, 85-6 and 91 (1960); *DuPage Utility Co. v. Illinois Commerce Commission*, 47 Ill. 2d 550, 554 and 558 (1971); and *Central Illinois Light Co. v. Illinois Commerce Commission*, 252 Ill. App. 3d 577, 583-3 (3rd Dist., 1993). See also *Business and Professional People for the Public Interest v. Illinois Commerce Commission* ("BPI II")*,* 146 Ill. 2d 175, 258 (1991). Since the alleged "pension asset" is funded by normal operations, rather than provided by discrete shareholder contributions, shareholders should not earn a return on it. (Staff Ex. 4.0, p. 4)

The Companies aver that the utility owns the alleged "pension asset" and the assets in the pension trust fund. However, it is not important who owns the assets in the pension trust fund. The important question is whether the alleged "pension asset" was created with funds from shareholders. Ownership is not determinative of ratemaking treatment. As Staff witness Pearce explained in rebuttal testimony (Staff

Ex. 14.0, p. 5), Peoples Gas owns the entire Compressed Natural Gas ("CNG") fueling station, but because it was constructed in part using funds from a federal Clean Cities grant administered by the City of Chicago, the Company may not include in its rate base the entire cost of the CNG fueling Station. In fact, the Company only sought to include in rate base the cost of the fueling station not covered by the federal grant. (NS-PGL Ex. 44.0, p. 1) Therefore, even if Peoples Gas or North Shore Gas owns the alleged "pension asset," and owns the assets in the pension trust fund, which Staff does not concede, it is simply not relevant to determining whether the alleged "pension asset" should be included in rate base. (Staff Ex. 14.0, pp. 5-6)

Moreover, Peoples Gas' and North Shore Gas' pension trust fund has an unfunded liability as of December 31, 2013 (i.e., the projected benefit obligation exceeds the balance of the assets in the pension trust.) Despite having a pension liability, however, the Companies allege to have a "pension asset" by arbitrarily adding to that pension liability a *regulatory asset* (see Line 2 of table below) whose amount far exceeds the pension liability.

Line	**Avg. Balance in Thousands**[5]	**Peoples Gas RTTY**	**North Shore RTTY**
1	Net Pension Funded Status Asset/(Liability)	($279,417)	($24,871)
2	Regulatory Asset/(Liability)	363,122	25,349
3	Total Pension Asset/(Liability)	$83,705	$478

[5] NS-PGL Ex. 27.6 N and P, lines 5, 10 and 11, column (D).

The Companies' regulatory asset associated with the pension plans reflects the assured future recovery from ratepayers of the underlying pension costs through utility rates. Hence, these pension costs will be paid for by ratepayers, not shareholders. It is counterintuitive and unreasonable to require ratepayers to provide a return to shareholders for a regulatory asset that only exists because ratepayers are responsible for providing recovery of the underlying expense. (Staff Ex. 4.0, p. 8)

Without the inclusion of this regulatory asset that clearly represents funds to be supplied by ratepayers in the future, Peoples Gas' alleged "pension asset" would disappear. (Staff Ex. 14.0, pp. 6 – 7) This would occur because, as Companies witness Ms. Phillips herself recognized, Peoples Gas' pension fund is underfunded, resulting in a pension liability and not a pension asset. (NS-PGL Ex. 31.2P, line 5, columns (F) and (G)) This is true whether Peoples Gas' proposed year-end rate base or Staff's proposed average rate base is adopted.

North Shore Gas did not seek to include a pension asset in its rebuttal rate base because North Shore's December 31, 2013 balance for pension costs reflects a pension liability, not an asset (that is, it is also underfunded). Under the year-end rate base proposed by North Shore, applying the "pension asset" calculation used by Peoples Gas (i.e., netting the pension liability with the regulatory asset) does not result in a positive amount that North Shore could claim as a "pension asset." (Staff Ex. 14.0, pp. 13 – 14) Thus, no adjustment is required under that scenario. Therefore, Staff proposes no adjustment to remove the North Shore pension liability if a year-end rate base methodology is approved. However, Staff witness Daniel G. Kahle proposes the use of an average rate base for the 2013 test year. (Staff Ex. 12.0) If an average rate base were adopted for North Shore and the same arguments and calculations proffered by Peoples Gas were applied, the Companies' schedules allege that North Shore would also have a "pension asset". (Ex. NS-PGL Ex. 31.2 N, line 13, column (G)) Therefore, Staff proposes to remove this amount, net of ADIT. (Staff Ex.14.0, Sch. 14.01 N)

As noted above, it is unreasonable to net the pension liability with a regulatory asset that reflects the recognition of assured future recovery from ratepayers of the pension expense. This novel treatment leads to the absurd result of making ratepayers pay utility shareholders a return on amounts that ratepayers will pay the utility in the future. (Staff Ex. 14.0, pp. 7 – 9)

The Companies have never established that the so-called "pension asset" was not created with funds collected from or to be collected from ratepayers. It is an uncontested fact that ratepayers pay for ongoing, periodic pension expense and other post-retirement benefits—not the shareholders. The Companies admit this fact. (*Id.*)

Accordingly, the Commission should adopt Staff's proposal to remove the alleged "pension asset" from the Companies' rate base regardless of whether a year end or average rate base is adopted. In so doing, the Commission is appropriately rejecting the novel argument that ratepayers today should be forced to pay utility shareholders a return on amounts that ratepayers will pay the utility in the future.

The Companies' assessment of past pension contributions' impact on ratepayers is not accurate.

The Companies' assertion that pension contributions exceeded expense by $77,546,609 during the period October 1, 1995 – December 31, 2013 is not an accurate assessment of the impact on ratepayers. The $77,546,609 difference between total pension expense of ($24,080,194) and total pension contributions of $53,466,415 for the 18-year period (1995 – 2013) (Staff Ex. 14.0, Att. A, p. 7) is due to negative amounts of pension expense in the years 1996 – 2003. Negative pension expense typically results when the expected return on plan assets exceeds other elements that make up pension expense. In other words, earnings on the pension assets exceeded pension costs during these periods; however, ratepayers did not receive the benefit of these negative expenses. In order for ratepayers to receive a direct benefit from these negative expenses, a rate case would have had to be filed that reflected the negative amounts in the revenue requirement. Peoples Gas did not seek a change in rates between 1995 and 2007 (i.e., Docket No. 95-0032 and Docket No. 07-0242). Therefore, the negative expense amounts have **not** been reflected in past utility rates. Moreover, Peoples Gas filed several rate cases since its rate case in Docket No. 95-0032. As shown in the table below, in the overwhelming majority of these rate cases, the Companies' pension expenses recovered from ratepayers through base rates exceeded actual pension contributions—the reverse of what the Companies claim. (Staff Ex. 14.0, p. 11) On a total basis, pension expense of $84,257,459 exceeds pension contribution of $17,164,995 by $67,092,464. In terms of magnitude, total pension expense is almost five times greater than the pension contributions.

General Rate Case	**Test Year**	**Pension Expense**	**Pension Contribution**
Docket No. 07-0242	Historic test year ended 9/30/06	$ 11,507,532	$ 16,207,282
Docket No. 09-0167	Future test year ended	$ 8,015,677	$ 121,123

	12/31/10		
Docket No. 11-0281	Future test year ended 12/31/12	$ 26,311,141	$ 499,673
Docket No. 12-0512	Future test year ending 12/31/13	$ 38,423,109	$ 336,917
Total		**$ 84,257,459**	**$ 17,164,995**

Source: Companies Response to DR BAP 23.01, Staff Ex. 14.0, Att. A.

Shareholders did not provide a higher level of contributions than the amount of pension expense that was reflected in rates in three of the four years shown above. Further, ratepayers did not directly benefit from a reduction in pension expense during the years that the pension fund was earning returns higher than was expected because the Company did not seek a change in rates during that period. The table above supports Staff's contention that ratepayers-- not shareholders-- have supplied the funds and will continue to supply the funds for employee pension benefits. The Commission should reject this unsubstantiated and highly inaccurate claim that the Companies have used to justify inclusion of the alleged "pension asset" in rate base.

The Commission has repeatedly rejected the Companies' arguments in the past and should do so again.

The Commission has rejected the Companies' position that the pension asset should be included in rate base in the previous three rate cases[6] filed by the Companies and the Illinois Appellate Court has upheld the Commission's final order in Docket Nos.

[6] The three previous rate cases are: Docket Nos. 07-0241/0242 (Cons.), Docket Nos. 09-0166/0167 (Cons.) and Docket Nos. 11-0280/0281 (Cons.) Docket Nos. 11-0280/0281 (Cons.) is still pending on appeal. The appeal of Docket Nos. 07-0241/0242 was dismissed as being moot on June 20, 2012.

09-0166/09-0167 (Cons.). The Companies acknowledge the fact that the Commission, in the three previously filed rate cases, has rejected their claims that an alleged "pension asset" should be included in the test year rate base. Nonetheless, in spite of the three prior Commission orders rejecting the Companies' position, as well as a ruling from the Illinois Appellate Court doing the same, the Companies continue to assert an alleged "pension asset" should be included in rate base. (Staff Ex. 4.0, pp. 9-10)

The Illinois Appellate Court upheld the Commission's January 22, 2010 Order in Docket No. 09-0166/09-0167 (Cons.). The Illinois Appellate Court stated:

> The central issue before us remains whether the Commission's decision to exclude the pension asset, which it found consisted of consumer-supplied funds, from Peoples Gas' rate base was against the manifest weight of the evidence. Both the Staff's and the People's expert witness testified the pension asset constituted customer-supplied revenues and, therefore, should be deducted from the rate base calculation.
>
> Although Peoples Gas' expert witness obviously disagreed with that assessment and testified the pension asset was generated solely from shareholder revenue, we note the credibility of expert witnesses and the weight to be given their testimony are generally matters for the Commission to determine as the finder of fact. See *Lefton Iron & Metal Co. v. Illinois Commerce Comm'n,* 174 Ill. App. 3d 1049, 1060 (1988). "Decisions of the Commission are entitled to great deference because they arise out of the deliberations of members who are much better qualified to interpret evidence supplied by specialists and technicians." *Id*. Accordingly, we must refrain from reevaluating the credibility or weight of the evidence, or from substituting our judgment for that of the Commission unless the Commission's judgment was clearly against the manifest weight of the evidence. See *Commonwealth Edison Co.*, 398 Ill. App. 3d at 514.
>
> Based on the record before us, we find the **Commission's decision with regard to the pension asset deduction is not clearly against the manifest weight of the evidence. Accordingly, we see no reason to disturb the Commission's findings**

Peoples v. Illinois Commerce Commission, Nos. 1-10-0654, 1-10-0655, 1-10-0936, 1-10-179, and 1-10-1846 and 1-10-1852, Consolidated, Appellate Court (First District-Fifth

Division) September 30, 2011, pp. 42-43, par. 69-71 (Emphasis added) (Staff Ex. 4.0, pp. 9-10)

The Companies have presented no new facts or evidence in the instant proceeding that would warrant a different conclusion from the Commission in this proceeding than it has reached in its order for the previous three rate cases one of which, 09-0166/0167 (Cons.) was upheld on appeal as discussed above. (*Id.*)

5. Net Operating Losses

The Companies indicated in their responses to certain Staff Data Requests ("DR"s) that they would address the impact of tax legislation that was enacted on January 2, 2013, including possibility of a Net Operating Loss ("NOL") in surrebuttal testimony. (Staff Ex. 14.0, p. 23) The Companies filed surrebuttal testimony on January 25, 2013 that reflects the impact of a NOL on the 2013 test year operating statement (NS-PGL Ex. 42.0) and rate base (NS-PGL Ex. 43.0) but does not incorporate the effect of the revenue increase on such NOL. Accordingly, the revenue requirements attached to Staff's Initial Brief contain two sets of adjustments to reflect the impact of Staff's proposed increase:

1) Operating Statement adjustments to reflect that Staff's proposed revenue increase results in a lower NOL and reduces the current tax provision, while increasing the deferred tax expense; and,

2) Rate Base adjustments to reflect that Staff's proposed revenue increase results in a lower NOL and reduces the ADIT asset, but not below zero, as in the case of North Shore Gas. This impact was confirmed by Companies' witness Ms. Moy during Staff's cross examination. (*Tr*., Feb. 8, 2013, p. 706)

Staff Cross Exhibit 4[7] was entered into the evidentiary record to more fully describe the relationship of the NOL to the current and deferred tax expenses in the final revenue requirement that is approved by the Commission in this proceeding. Staff Cross Exhibit No. 10[8] was also entered into the evidentiary record to more fully describe the relationship of the NOL to the ADIT asset.

Accordingly, Staff adjusted the revenue requirements attached to this Initial Brief to reflect a lower ADIT asset in the test year rate base.

Companies' witness Stabile also confirmed that if the 2012 NOL is not included in the beginning balance for the 2013 NOL, then this would be a violation of Federal Income Tax normalization rules which would result in the loss of accelerated depreciation, including bonus depreciation. (*Tr*., Feb. 8, 2013, p. 777)

Therefore, the Commission should reflect derivative NOL adjustments in the final operating statement and rate base schedules for the Companies based on the amount of revenue increase that is ultimately approved in this proceeding. It is Staff's understanding that the methodology to reflect the impact of the revenue increase on the NOL and final revenue requirements is not contested between Staff and the Companies.

[7] Staff DR BAP 26.02.
[8] Response to Staff DR BAP 26.01.

6. Accumulated Deferred Income Taxes

a. Appropriate Methodology to Reflect Change in State Income Tax Rate

Intervenor witness Brosch (AG Ex. 4.0, p. 41; AG Ex. 4.1 and 4.2, Schs. B-4) proposed an adjustment to reduce the ADIT provision to reflect the impact of scheduled decreases in the state income tax rate effective 2015 and again in 2025.

The Companies maintain their methodology of calculating ADIT using Average Rate Assumption Method ("ARAM") is consistent with the Commission's final order in Docket No. 83-0309; therefore, further adjustments are unnecessary. (NS-PGL Ex. 46.0, pp. 2 – 19)

Staff did not take issue with the Companies' position, noting that based on Staff's understanding of the order in Docket No. 83-0309, the methodology appears reasonable. (Staff Ex. 14.0, pp. 21 - 22)

b. Repairs Deduction Related to AMRP projects

In its direct filing, Peoples Gas assumed approximately 40% of AMRP costs would qualify for immediate tax deduction as repairs and maintenance expenses. Based on further developments in the treatment of electric transmission and distribution ("T & D") costs by the Internal Revenue Service ("IRS"), the Company changed its tax position regarding AMRP costs, asserting the tax deductions in the Companies' direct filing are not supportable given the guidance issued for electric T & D companies. Without a reasonable expectation that the IRS will allow these deductions, the Company does not intend to take the position on an originally filed tax return or amended claim. Peoples Gas asserts that GAAP would not permit recognition of the tax benefits and resulting deferred taxes. Therefore, in rebuttal testimony, Peoples Gas decreased its deferred tax liability by $47.2 million as of December 31, 2013 reflecting AMRP costs being capitalized instead of expensed. (NS-PGL Ex. 30.0, pp. 17 – 20)

Intervenor witness Effron concluded Peoples Gas had not substantiated the basis for its change in tax accounting method for AMRP costs and proposed to restore the Company's deferred tax benefit related to expense treatment of such costs. Mr. Effron's adjustment assumes an average rate base methodology that would increase the ADIT liability and reduce average rate base by $32.347 million. (AG Ex. 5.0, pp. 4 – 9; AG Ex. 5.1.)

Neither Staff nor CUB-City witness Smith contested the Companies' position.

c. Bonus Depreciation

d. Derivative Adjustments from Contested Adjustments

D. Accumulated Depreciation (Uncontested Except for Derivative Adjustments from Contested Adjustments)

V. OPERATING EXPENSES

A. Overview/Summary/Totals

1. North Shore

Staff recommends total operating expenses before income taxes of $61,832,000 as reflected on page 1 of Appendix A to Staff's Initial Brief.

2. Peoples Gas

Staff recommends total operating expenses before income taxes of $433,903,000 as reflected on page 1 of Appendix B to Staff's Initial Brief.

B. Potentially Uncontested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

1. Administrative & General

a. Interest Expense on Budget Payment Plan

The parties are in agreement that the 0.0% interest rate set by the Commission on customer deposits should be use to calculate interest expense on Budget Payment Plan Balances. (Order, Docket No. 12-0686, December 19, 2012, p. 2; NS-PGL Ex. 42.0, p. 12)

b. Interest Expense on Customer Deposits

The parties are in agreement that the 0.0% interest rate set by the Commission on customer deposits should be use to calculate interest expense on Budget Payment Plan Balances. (Order, Docket No. 12-0686, December 19, 2012, p. 2; NS-PGL Ex. 42.0, p. 12)

c. Lobbying expenses

Staff proposed adjustments to disallow expenses inherent with lobbying and related activity which were incorporated in the Companies' filing. (Staff Ex. 3.0, pp. 16-17; Schs. 3.05 N and P) The adjustments included membership dues paid to the Business and Industry Federation of Economic Concern and the Illinois Environmental Regulatory Group, since a review of these organizations' web sites indicates that lobbying activities are their primary business purpose. The Companies accepted Staff's adjustments in rebuttal testimony. (NS-PGL Ex. 26.0, p. 5)

d. Social and Service Club Dues

Staff proposed adjustments to remove certain social and service club membership dues from the Companies' recoverable miscellaneous general expenses. (Staff Ex. 3.0, p. 15; Schs. 3.04 N and P) The adjustment included amounts for the following organizations: Chicagoland Chamber of Commerce, City Club of Chicago, Lake County Chamber of Commerce, Illinois Chamber of Commerce, and Illinois Manufacturers Association. (See Sch. 3.04 N, p. 2 and Sch. 3.04 P, p. 2, for a complete listing) The Companies accepted Staff's adjustments in rebuttal testimony. (NS-PGL Ex. 26.0, p. 5)

e. Executive Perquisites

Staff proposed adjustments to remove the amount of executive perquisites included in test year operating expenses for each of the Companies. (Staff Ex. 3.0, pp. 17-18) The specific costs disallowed included annual physicals, life insurance, and flexible perquisite allowances to cover financial planning, tax planning and office equipment. The Companies accepted Staff's adjustments in rebuttal testimony. (NS-PGL Ex. 26.0, p. 5)

f. Consulting Expense – SIG Consulting

Staff proposed adjustments to remove from test year operating expenses the amount of consulting expenses for Strategic International Group, LLC ("SIG") since the Companies indicated that they no longer sought cost recovery of such costs. (Staff Ex.

3.0, pp. 20-21) The Companies accepted Staff's adjustments in rebuttal testimony. (NS-PGL Ex. 26.0, p. 5)

g. Employee/Retiree Perquisites – Awassa Lodge

Staff witness Pearce (Staff Ex. 4.0, Sch. 4.05 P) proposed to remove the test year expense associated with Awassa Lodge that was charged to Peoples Gas by Integrys Business Support, LLC ("IBS"). The reason for Staff's adjustment is that these charges represent employee and retiree recreational perquisites that are not an ordinary or necessary cost of providing utility service. Accordingly, it is not reasonable for these types of benefits to be charged to ratepayers. (Staff Ex. 4.0, pp. 23 – 25) The Company accepted Staff's adjustment in the rebuttal testimony of witness Sharon Moy. (NS-PGL Ex. 26.0, p.5; NS-PGL Ex. 26.2 P, p. 3, column (I)) Accordingly, this adjustment is no longer contested.

h. Update to Pension and Benefits

The Companies updated in rebuttal testimony the estimated test year pension and benefits costs to reflect the most recent actuarial valuation. (NS-PGL Ex. 26.0, p. 14; NS-PGL Ex. 31.0, pp. 3 - 8) No parties contested the amount of updated pension and benefits costs.

i. Updated IBS Return on Investment

AG witness Brosch proposed an adjustment to correct the IBS calculation of return on investment charged to the Utilities. (AG Ex. 1.0, p. 51; AG Ex. 1.3 and 1.4, Schs. C-9) The Companies accepted this adjustment in the rebuttal testimony of witness Sharon Moy. (NS-PGL Ex. 26.0, p. 5; NS-PGL Ex. 26.2 N and P, p. 1, column (F)) Accordingly, this adjustment is no longer contested.

j. Costs to Achieve Amortization

The Companies revised the amortization of "costs to achieve" in accordance with the Commission Order in Docket Nos. 11-0280/11-0281 (Cons.), as noted in response to Staff DR JMO-6.04. (NS-PGL Ex. 26.0, p. 13; NS-PGL Ex. 26.2 N and P, p. 1, column (E)) No parties contested the revised amount of "costs to achieve."

2. Uncollectible Account Expense Included in Base Rates

Staff witness Kahle recommended that the Final Order in this proceeding include a finding and ordering paragraph that states:

> (x) It is further ordered that the uncollectibles expense included in base rates for Peoples Gas is $xxx and North Shore is $yyy.

The above amounts are included in Appendices A and B, page 1, column (i), line 6. The Companies accepted Staff's recommended language for the Order in rebuttal testimony.[9]

3. Depreciation Expense

a. WAM System

b. CNG Plant

4. Income Tax Expense – Changes in Interest Expense on Debt Financing

[9] NS-PGL Ex. 26.0, p. 6

5. Revenues

a. Sales and Revenue Adjustment by Service Classification

6. Interest Synchronization (methodology on derivative adjustments)

C. Potentially Contested Issues (All Subjects Relate to NS and PGL Unless Otherwise Noted)

1. Incentive Compensation (Falls in Multiple Categories of O&M)

AG witness Mr. Michael Brosch and CUB-City witness Mr. Ralph Smith recommend disallowance of the expenses related to the operation and maintenance ("O&M") cost control metric which comprises 50% of the Non-Executive Incentive Compensation Plan's ("NEICP") costs. The primary basis for their disallowance is that the Companies did not show how ratepayers will benefit from O&M expenses being controlled or reduced relative to forecasted expense levels. (AG Ex. 1.0, pp. 31-32; CUB-City Ex. 1.0, p. 69) In surrebuttal testimony, the Companies presented additional documentation demonstrating that the O&M cost control metric provides benefits to ratepayers, and that recovery of the related incentive compensation costs is consistent with prior Commission practice. (NS-PGL Ex. 45.0, pp. 2-11) Staff agrees that the Companies' rebuttal and surrebuttal testimonies document ratepayer benefits related to the NEICP's O&M cost control metric. Therefore, Staff recommends that the Commission not accept Mr. Brosch's or Mr. Smith's proposed adjustments. (Staff Ex. 13.0, p. 25)

2. Wage Increase Corrections

3. Non-union Base Wages (Falls in Multiple Categories of O&M)

The Commission should accept Staff's adjustment to reduce the amount of non-union wage increases to a more reasonable amount. Staff's adjustment is calculated using the 3% non-union wage increase granted in February 2012 for 2012 non-union wage increases and the 2012-2016 Consumer Price Index ("CPI") inflation rate of 2.28% as forecasted by the Survey of Professional Forecasters for the 2013 non-union wage increases. Staff used these rates to escalate the Companies' 2011 actual non-union base wages to determine test year non-union base wages. (Staff Ex. 3.0, p. 12) Staff revised its adjustment for the rate base components, accumulated depreciation, and accumulated deferred income taxes to reflect the impact of the Companies' adoption of bonus depreciation in their surrebuttal testimony. (Staff Ex. 25.0, p. 2 and Schs. 25.01 N and P Revised)

In rebuttal testimony the Companies offered the World at Work Salary Budget Survey as support for the 2013 test year non-union wage increase of 3.45%. (NS-PGL Ex. 29.0, pp. 17-18) This source is the same source that was used by the Companies in the 2011 rate cases, which was rejected by the Commission. (Staff Ex. 13.0, p. 10) The Commission should reject the World at Work Survey again. Staff bases its recommendation on the Survey of Professional Forecasters rather than World at Work Survey results since it is a more forward-looking study projecting 2012-2016 increases. This forward looking projection is more in line with the period that rates will be in effect, rather than the single year (2012-2013) projected in the World at Work Survey. The

Companies cited to the Bureau of Labor Statistics Employment Cost Index ("BLS Index") as support in their rebuttal position. Staff opines that even though the BLS Index is a backward looking study, its results support the reasonableness of Staff's position in that it also measured a 2.3% wage increase for the utility industry for the 12 months ended September 2012. (Staff Ex. 13.0, p. 11) Based on the evidence in the record, Staff's adjustment to reduce the amount of non-union wages increases to a more reasonable amount based upon the CPI forecast is appropriate and should be adopted by the Commission.

4. Vacancy Adjustment (Falls in Multiple Categories of O&M)

AG witness Brosch and CUB-City witness Smith propose to reduce the Companies' operating expenses for an average vacancy factor which is based on actual versus authorized but unfilled employee positions during the first nine months of 2012. (AG Ex. 1.0, pp. 19-20; CUB-City Ex. 1.0, pp. 52-55) The Companies responded that employee levels will be equivalent to forecasted employee levels and the related expenses of such should be reflected in the Companies' test year operating expenses. (NS-PGL Ex. 28.0, pp. 13-14) Staff did not adjust the union wages for a vacancy factor; however, Staff did adjust the increase to non-union wages for a vacancy factor.

Staff's adjustment to non-union wages, discussed above (V. C. 3.), contains a similar impact as a vacancy factor adjustment. To calculate test year non-union wages, Staff escalated the 2011 actual non-union wages by the general wage increase given in 2012 and by Staff's recommended percentage increase for 2013. Staff's calculated test year non-union wages did not include the impact of wage increases for the forecasted additional headcount for 2012 and 2013. (Staff Ex. 3.0, Schs. 3.03 N and P, p. 3)

Therefore, as was recommended above in section V.C. 3, Staff's adjustment to decrease non-union wages to a more reasonable amount is appropriate and should be adopted by the Commission.

5. Distribution O&M

a. Plastic Pipefitting Remediation Project

Staff witness Brett Seagle recommended Peoples Gas O&M expenses be adjusted by $2,000,000 due to a remediation project involving the replacement of plastic pipefittings that, when installed, did not comply with certain industry standards referenced in Part 192 of Title 49 of the Code of Federal Regulations ("CFR"). (Staff Ex. 16.0, p. 1) In Mr. Seagle's opinion, the Company failed to demonstrate that the costs associated with the project were just and reasonable. (*Id.,* p. 7) Further, if the Company had initially complied with the 83 Ill. Adm. Code 590, the Company would not have incurred these costs. Sections 191.1, 191.3, 191.5, 191.7, 191.9, 191.11, 191.13, 191.15, 191.17, 191.23, 192, 193 and 199 are the minimum standards for transportation of gas and gas pipeline facilities. If a gas utility's distribution facilities do not comply with the Title 49 CFR that the Commission has adopted, then a violation of both federal and Commission rules exists. (Staff Ex. 6.0, p. 9) The Commission came to a similar conclusion in Docket No. 07-0585/0586/0587/0588/0589/0590 Cons.[10] (*Id.*, p. 10)

Peoples Gas argues that although an industry-recognized expert concluded the fittings were safe, the reasonable course of action was to replace them at the time that

[10] In Docket No. 07-0585/0586/0587/0588/0589/0590 Cons., the Commission did not pass costs on to ratepayers where the companies in that proceeding failed to comply with certain National Electrical Safety Code rules which were adopted in the Commission's Rules of Practice in 83 Ill. Adm. Code 305. (Order, Docket No. 07-0585/0586/0587/0588/0589/0590 Cons., September 24, 2008, p. 142)

they did for convenience purposes, regardless of the fact that the Company could have sought a special permit to allow the pipefittings to remain in service. (PGL Ex. 28.0, p. 12) As Staff witness Darin Burk testified, the Company's ability to seek a special permit is in doubt because the Company would have been required to seek the special permit and demonstrate that safety will not be compromised *prior* to installing the non-approved material or component, as required by 49 CFR Section 193.341(b) of the Pipeline Hazardous Materials Safety Administration's ("PHMSA") Guidance for State Programs. (Staff Ex. 19.0, pp. 5-6; Staff Ex. 19.0, Attachment 3) Mr. Burk contends that PHMSA would not have granted a special permit.

Peoples Gas argues that Mr. Burk incorrectly relies on subsection 190.341(b) which requires that the operator submit the application for the special permit at least 120 days prior to the effective date of the granting of the special permit, and that in the past, PHMSA has granted special permits after non-compliant equipment was installed. (NS-PGL Ex. 44.0, pp. 6-7) Staff disagrees. The issue is that the pipes were unmarked as required by Section 192.63. (Staff Ex. 19.0, p. 6) Peoples Gas admits the pipes were not properly marked and were installed without obtaining a special permit. (NS-PGL Ex. 44.0, p. 7) The installation of the fittings was not just and reasonable and the costs to replace the fittings should not be absorbed by the customers.

b. Legacy Sewer Lateral Cross Bore Program

Peoples and North Shore are seeking recovery of significant expenses related to a Legacy Sewer Lateral Cross Bore Program. (Staff Ex. 16.0, p. 9) Cross bores are gas pipelines through sewer lines. The Cross Bore Program is a remediation project involving locating existing cross bores in the system and, if one exists, rerouting the plastic main or service below, above or around the existing sewer facilities. (Staff Ex. 6.0, p. 12) Staff witness Brett Seagle recommended Peoples Gas O&M expenses be adjusted by $5,700,000 to exclude costs for the Legacy Sewer Lateral Cross Bore Program. (Staff Ex. 16.0, p. 1) Mr. Seagle recommended a similar adjustment of $2,600,000 for North Shore. (*Id.*) Mr. Seagle states that the Utilities did not demonstrate that the costs associated with this Program were prudent and reasonable. (Staff Ex. 6.0, pp. 12-13)

Staff witness Darin Burk disagrees with Peoples Gas' characterization that "cross bores are a circumstance beyond the Utilities' control." (Staff Ex. 19.0, p. 4, quoting NS-PGL Ex. 28.0, p. 7) 49 CFR Section 192.605 requires operators of natural gas pipelines to develop manuals of procedures for conducting operations and maintenance activities and for emergency response. Such procedures are to be in place prior to conducting operation and maintenance functions. Pipeline replacement is considered an operation and maintenance function according to PHMSA. A prudent operator must have procedures that allow for the positive identification of the location of all underground utilities and substructures when directional drilling or boring is to be used for the installation of gas pipelines. Even when the approximate location of an underground facility has been identified and marked, the depth of the facility must be confirmed to avoid contact during the directional drilling process. The procedures must include methods to confirm that spatial separation of utilities has been maintained. According to a PHMSA Advisory Bulletin issued in 1999, operators must review their procedures to identify hazards associated with directional drilling. (Staff Ex. 19.0, pp. 4-5; Staff Ex. 19.0, Attachment 1) Peoples must also follow industry guidance as laid out in the Gas Piping Technology Committee ("GPTC") Guide for Gas Transmission and Distribution Piping Systems ("GPTC Guidance"). (Staff Ex. 19.0, Attachment 2)

Mr. Burk opines that the fact that Peoples Gas has identified other locations where gas pipelines have been bored through sewers (NS-PGL Ex. 28.0 Rev., pp. 6-7) establishes that the Company's procedures were either inadequate or were not followed. (Staff Ex. 19.0, p. 5)

Utilities' witness Kyle Hoops states that because Peoples Gas provides detailed training to its employees and "has learned and continues to learn about the complexity of the City of Chicago's underground sewer system" that the costs related to the Legacy Sewer Lateral Cross Bore Program are prudent and reasonable. (NS-PGL Ex. 44.0, pp. 4-5) Mr. Hoops' reasoning is flawed. What Peoples may or may not have learned about cross-boring since the date it initially discovered its errors is irrelevant and does not show that the Utilities management acted prudently in developing the Companies' rules and regulations related to cross bores, or that those rules and regulations were adequate for the respective territories, especially the City of Chicago with its complicated system of pipes (Staff Ex. 19.0, pp. 4-5); nor, does it prove that the costs expended under the program are prudent and reasonable. Because the Companies cannot demonstrate that the costs associated with this Program were prudent and reasonable the Commission should accept Staff's proposed adjustments and exclude the costs from rate base.

c. New Chicago Department of Transportation Regulations

Staff witness Seagle testified in his direct testimony that he could not determine the just and reasonableness of Peoples Gas' request for the inclusion of O&M expenses for compliance with new Chicago Department of Transportation ("CDOT") regulations, because Peoples Gas did not make its request until it filed supplemental direct testimony which did not provide Staff with sufficient time to investigate Peoples Gas' request. (Staff Ex. 6.0, p. 15) As a result, Mr. Seagle requested that Peoples Gas provide additional information to support its request. Based on the additional information that Peoples Gas provided, Mr. Seagle was satisfied that the calculation of costs associated with the new CDOT regulations was just and reasonable, and therefore, Mr. Seagle withdrew his objections to Peoples Gas' request for the additional costs associated with complying with CDOT's regulations. (Staff Ex. 16.0, p. 6)

6. Productivity Adjustment

AG witness Brosch recommends a one-half of one percent productivity adjustment to reduce the Companies' 2012 and 2013 test year non-fuel O&M expenses. His adjustment is based upon the expectation that management should achieve annual productivity improvement. (AG Ex. 1.0, p. 25) Companies' witness Ms. Christine Gregor does not agree with the productivity adjustment due to the lack of support for the proposed adjustment. Ms. Gregor points out that Mr. Brosch stated that the Companies should be expected to achieve productivity targets applicable to other utilities. She noted that his cites to California and New York cases provide no evidence regarding the productivity factors derived in those cases or how they would apply to the Companies. Mr. Brosch also cited to a productivity adjustment in a Hawaii case, which utilized a ratemaking approach not comparable to the current proceeding. (NS-PGL Ex. 41.0, p. 7) Staff agrees with the Companies that Mr. Brosch has not provided sufficient support for the proposed productivity adjustment. Therefore, Staff recommends that the

Commission should not accept Mr. Brosch's proposed productivity adjustment. (Staff Ex. 13.0, p. 23)

7. Administrative & General

a. Adjustments to Integrys Business Support costs

Staff witness Pearce proposed an adjustment to reduce intercompany charges from IBS to Peoples Gas in direct testimony. (Staff Ex. 4.0, pp. 13 – 16; Sch. 4.02 P) This adjustment was revised in Staff's rebuttal testimony. (Staff Ex. 14.0, pp. 16 – 19; Sch. 14.02 P)

AG witness Brosch also proposed an adjustment to reduce IBS charges to Peoples Gas, as well as North Shore Gas in direct testimony. (AG Ex. 1.0, pp. 48 – 51; AG Ex. 1.3 and 1.4, Schs. C-8.) He also revised these adjustments in rebuttal testimony. (AG Ex. 4.0, pp. 50 – 56; AG Ex. 4.1 and 4.2, Schs. C-8)

The Companies contend that no adjustment is necessary because intercompany charges have been adequately supported for the 2013 test year. Staff and AG witness Brosch assert these costs have not been shown by the Companies to be reasonable, for various reasons.

The Companies have failed to support the significantly higher level of test year intercompany charges from IBS, even after allowing for the overall inflation adjustment of 2.2 percent that was used by the Companies in their test year forecast. This is demonstrated in Staff witness Pearce's comparison of test year IBS charges to the five-year average calculated in Staff's direct and rebuttal testimony. (Staff Ex. 14.0, Sch. 14.02 P; Staff Ex. 4.0, Sch. 4.02 P)

In direct testimony, Staff witness Pearce performed an analysis of intercompany charges from IBS to Peoples Gas that compared monthly and annual costs over the five- year period 2008 through the first nine months of 2012, using actual cost data provided by the Company. She also reviewed the Company's response to Staff DR BAP- 2.06 (d), which provided explanations for fluctuations within individual cost categories over the four year period 2008 – 2011, based on actual costs. Based on this information, Ms. Pearce concluded that Peoples Gas supported only $7.621 million of its requested $15.744 million increase. (Sch. 4.02 P, p. 1) She utilized a five-year average for the period 2008 – 2012 as the basis for this adjustment. For 2012, Ms. Pearce relied upon actual data for the first nine months, annualized to estimate the yearly total. That amount, along with actual charges for the previous four years (2008 – 2011) is reflected on Schedule 4.02 P, page 2. As the notes on page 2 indicate, this information was taken from annual reports submitted by the Company pursuant to Section 4.5 of the Master Affiliated Agreement approved in Docket No. 07-0361. Ms. Pearce also verified that the cost information provided by the Company for the months of July 2011 through September 2012 agreed with monthly IBS invoices received by the Company. Companies' witness Christine M. Gregor agreed the increases in IBS costs were not clearly explained by the Companies, but she declined to accept Staff's adjustment, claiming the amount of disallowed expense consists mainly of increases in benefit costs and injuries and damages expenses. (NS-PGL Ex. 25.0)

In rebuttal testimony, Ms. Pearce revised this adjustment to include the actual charges for October and November 2012 in the annualized 2012 expense, and to apply the Company's overall inflation rate of 2.2% in lieu of recognizing increases in expenses for depreciation, rate case, and legal costs. (Staff Ex. 14.0, pp. 16 – 19; Sch. 14.02 P, pp. 1 – 3.)

Staff contends that the Company has attempted to justify an unreasonably high level of intercompany charges in the future test year by selectively addressing increases in two areas of expense. Given the magnitude and variety of costs that flow through the intercompany charges (from IBS to Peoples Gas), Ms. Gregor's explanation does not support the overall level of increase, 10.68%. (Staff Ex. 14.02 P) For example, even if expenses increased in the areas of benefits costs and injuries and damages, other intercompany charges may have also declined that would offset the two increases selectively chosen by Ms. Gregor.

Ms. Gregor argued that Staff's use of a five-year average of total actual intercompany charges was improper because it included 2008. She claimed that 2008 was not a representative year because IBS did not handle certain charges in 2008. Staff performed an analysis that demonstrated excluding 2008, as the Companies would have had Staff do, would result in a four-year average with an even greater disparity to the 2013 test year forecast for intercompany charges from IBS to Peoples Gas. Thus, an even larger adjustment than Staff proposed in rebuttal testimony would have been warranted if the Companies' critique to remove 2008 was addressed. Specifically, the five-year average that Ms. Pearce calculated (Staff Ex. 14.0, Sch. 14.02 P, p. 2) produces an average annual total intercompany charge of $145,345,324 versus $141,349,998 for a four-year average without 2008. (*Id.*, p. 3) Using the four-year average would result in an adjustment even greater than Staff recommended since the adjustment would be derived by taking the 2013 test year forecast for intercompany charges of $160,870,000 (*Id.*, p. 2) less the smaller four-year average annual total intercompany charge. Given that the five-year average is less than three percent greater than the four-year average, the impact of 2008 does not seem to be significant to the estimate overall.

Accordingly, Staff urges the Commission to accept its adjustment to reduce intercompany charges from IBS to Peoples Gas. Staff contends this will cause intercompany charges to align more closely with the five-year average calculated on Staff Ex. 14.0, Sch. 14.02 P, page 2 of 3, as adjusted for the overall rate of inflation utilized by the Utilities in the 2013 test year, 2.2%, discussed on Peoples Gas' Schedule G-5, page 10 of 12, Note G.

Additionally, Staff notes that AG witness Brosch and Staff witness Pearce took different approaches to their adjustments. Overall, Mr. Brosch reduced future test year Peoples Gas operating expenses in four components (excluding individual adjustments for specific items like incentive compensation, DOT and cross-bores): productivity increases that were not reflected in the forecast; reduced costs related to vacancy factors; and specific adjustments targeted to IBS intercompany charges for overstatement of expense and return on investment. Staff's adjustment, in contrast, was calculated using a simple five-year average and applying the Company's general inflation factor for the test year. Both AG witness Brosch and Staff witness Pearce concluded the Company had not supported the reasonableness of the future test year level of operating expenses it seeks. The following comparison demonstrates that the sum of Mr. Brosch's general operating expense reductions, as compared to Staff's general IBS intercompany expense reduction, is not significantly different in total dollar impact. While Staff does not endorse the AG methodology[11], the record is clear that the Companies proposed A&G expenses are not reasonable forecasts and must be adjusted.

Line No.		Brosch Rebuttal Testimony:	Amount
1		Sch. C-8, Overstatement of IBS expense	($2,084,000)
2		Sch. C-9, ROI adjustment for IBS charges	(40,000)
3		Vacancy adjustment	(7,550,000)
4		Productivity adjustment	(2,492,000)
5		Total general operating adjustments (Lines 1 - 4)	**($12,166,000)**
		Pearce Rebuttal Testimony:	
6		Sch. 14.02 P Reduction to intercompany IBS charges	**($12,327,000)**
7		**Difference between Brosch and Pearce adjustments (Line 5 minus line 6)**	**$161,000**

b. Advertising Expenses

The Commission should accept Staff's adjustments to remove advertising expenses that are of a promotional, goodwill or institutional nature, and are therefore barred from cost recovery under Section 9-225 of the Act. (Staff Ex. 3.0, p. 19; 220 ILCS 5/9-225) The Companies agreed that certain advertising expenses could be considered promotional, goodwill, or institutional in nature. (NS-PGL Ex. 26.0, p. 6) However, the support for the Companies' acceptance of disallowed advertising

[11] See Sections V. C. 4 and 6: Productivity and Vacancy Adjustments

expenses is not clearly stated. It appears that the Companies divided the 2011 sponsorships into two groups: sponsorships they identified as allowable and the remaining sponsorships as a part of Staff's disallowance. (Staff Ex. 13.0, p. 14 and Schs. 13.03 N and P, p. 3) There is no readily apparent difference between the two groups to demonstrate why a sponsorship was or was not deemed allowable for recovery from ratepayers.

The Companies argue that sponsorships should be recoverable from ratepayers because sponsorships: 1) support events and organizations that are valued by communities the Companies serve; 2) enable the Companies to provide information on energy education, online billing and energy assistance to event attendees; and 3) represent charitable contributions. (NS-PGL Ex. 26.0, p.7) Staff asserts that these arguments are meritless for the following reasons.

First, the assertion that communities in the Companies' service territories would value sponsorships of events and organizations has no bearing on whether the expense of such sponsorships should be recovered from ratepayers. The sponsorships put the Companies' name before the public in a philanthropic light, and therefore, must be disallowed in compliance with Section 9-225 of the Act and prior Commission orders. (Staff Ex. 13.0, p. 15)

Second, the assertion that the sponsorships enable the Companies to provide relevant information to event attendees has not been substantiated with the provision of advertising materials as required by Section 9-226 of the Act. (220 ILCS 5/9-226) The only support the Companies provided was informational messaging concerning the Companies' system and safety. (NS-PGL Ex. 42.3) Based on the information provided by the Companies to show that the requirements of Section 9-226 of the Act have been met, it is not possible to determine what advertising materials were provided, and for which sponsored event. The Companies merely assert that the events' advertising materials contain information that would "allow for the Companies to promote a number of initiatives including energy efficiency programs, safety and financial assistance directly to customers." The support to substantiate the Companies' claim, as required by Section 9-226 of the Act, is not contained within the record of this proceeding. (Staff Ex. 13.0, pp. 15-16) Therefore, cost recovery must be denied.

Third, the assertion that event sponsorships are charitable contributions is not corroborated with the charitable contributions listed on the Companies' Schedules C-7 as required by 83 Ill. Admin. Code 285. The Companies filed their rate cases requesting that these costs be recovered as advertising costs. This Commission should not allow recovery of these advertising costs because the Companies have decided in the middle of this proceeding that these costs are now charitable contributions. (Staff Ex. 13.0, p. 16) The Companies contend that when a contribution is made to a charity by sponsoring an event, where information about energy efficiency and/or safety is provided, the expense should be allowable regardless of whether it is recorded as a charitable contribution or as an advertising expense. (NS-PGL Ex. 42.0, p. 8) However, recording an expense in the proper account does not mean that the Companies' should be allowed to recover that expense – rather the standards for recoverability are set out in the Act. The Commission does not commit itself to the approval or acceptance of any item set out in any account, for the purpose of fixing rates or in determining other matters before the Commission. (83 Ill. Adm. Code 505.210) The fact that the expense of sponsorships could be recorded in certain accounts, does not guarantee that the Commission will allow such expenses in rates.

As pointed out in Staff's testimony, the Commission previously disallowed goodwill advertising expenses from the Companies' rates. (Staff Ex. 3.0, p. 20) The adjustments Staff recommends to remove advertising expenses that are of a promotional, goodwill or institutional in nature are appropriate and should be adopted by the Commission.

c. Charitable Contributions

The Commission should accept Staff's adjustment to reduce test year charitable contributions by $8,000 for the disallowance of contributions made by Peoples Gas to organizations outside the Company's service territory, since there is no tangible evidence that these contributions provide any benefit to Peoples Gas' ratepayers. (Staff Ex. 3.0, p. 21; Sch. 3.09 P)

Peoples Gas operates a corporate program whereby it matches employee donations to nonprofit organizations. Peoples Gas made matching contributions to colleges and universities located outside of Peoples Gas' service territory. The Company provided no tangible evidence that these contributions provide any reasonable benefit to Peoples Gas' rate payers. (Staff Ex. 3.0, pp. 21-22) Staff's adjustment is consistent with the Commission's recent orders (Docket Nos. 12-0321, 10-0467, 11-0721, and 12-0001) that disallow contributions to organizations outside a utility's service territory. (Staff Ex. 13.0, p. 21)

Staff's recommended disallowance to test year charitable contributions for contributions made by Peoples Gas to organizations outside the Company's service territory is appropriate and should be adopted by the Commission.

d. Institutional Events

The Commission should accept Staff's adjustment to reduce test year miscellaneous operating expenses for institutional events annual fund-raising support because they are either of a promotional, goodwill or institutional nature, not necessary to provide utility service to rate payers, and are, therefore, barred for cost recovery under Section 9-225 of the Act. (Staff Ex. 10.0 Supp., p. 3)

The Companies' supporting documentation for institutional events annual fund-raising support revealed that the Companies purchased table sponsorships for their employees to attend breakfast/luncheon/dinner events where the Companies received recognition in promotional materials and verbal acknowledgement from the event podium. (Staff Cross Ex. 5) These expenses should not be considered for rate making purposes, because such fund-raising support brings the Companies' names before the general public in such a way as to improve the Companies' image. Support of fund-raising events, while promoting good corporate citizenship, are of a promotional and goodwill nature, are not necessary to provide utility service, and provide no direct benefit to ratepayers. (Staff Ex. 10.0, pp. 3-4) The Act requires costs "designed primarily to bring the utility's name before the general public in such a way to improve the image of the utility or to promote controversial issues for the utility or the industry" to not be included in rates. (220 ILCS 5/9-225(d) and 9-225(2))

The Companies agreed that certain institutional events annual fund-raising support could be considered promotional, goodwill or institutional in nature. (NS-PGL Ex. 26.0, p. 10) Similar to the acceptance of Staff's disallowance adjustments for advertising expenses discussed above, the support for the Companies' acceptance of disallowed institutional events support is lacking and opaque. It appears that the Companies' divided the 2011 events sponsorships into two groups: sponsorships identified as allowable (NS-PGL Ex. 26.3 N and P) and the remaining sponsorships as a part of Staff's disallowance. (Staff Ex. 13.0, p. 18; Schs. 13.04 N and P, p. 1) There is no readily apparent difference between the two groups that demonstrates the reasons a sponsorship was or was not deemed allowable for recovery from ratepayers.

In rebuttal testimony, the Companies' portray support of institutional events as charitable contributions. (NS-PGL Ex. 26.0, pp. 9-10) This portrayal is misleading. The Companies already make charitable contributions to a number of these organizations in addition to providing support for their fundraising events. Whether the Companies record institutional events support costs as miscellaneous general operating expense or charitable contributions, should not dictate whether these particular miscellaneous general operating expenses should be recovered from ratepayers. The Companies have provided no evidence that the costs of their fund-raising event sponsorships are anything other than goodwill advertising costs, which are barred from cost recovery by the Act. (Staff Ex. 13.0, pp. 18-19) The adjustments Staff recommends to reduce test year miscellaneous operating expenses for institutional events annual fund-raising support because they are either of a promotional, goodwill or institutional nature are appropriate and should be adopted by the Commission.

8. Depreciation

a. Bonus Depreciation

b. Derivative Adjustments from Contested Adjustments

9. Rate Case Expenses

Section 9-229 of the Act states:

> The Commission shall specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. This issue shall be expressly addressed in the Commission's final order.

(220 ILCS 5/9-229)

Staff witness Rochelle Phipps, a Senior Financial Analyst in the Finance Department of the Financial Analysis Division, presented her review of the rate case expense associated with the testimony of Mr. Paul R. Moul, who testified regarding the cost of common equity for the Companies. Ms. Phipps reviewed the Companies' Schedule C-10, as well as the Companies' responses to Staff DRs, which included invoices for the rate case expense associated with Mr. Moul's testimony. She did not propose an adjustment to the rate case expense associated with Mr. Moul's testimony. (Staff Ex. 22.0)

Staff witness William Johnson, an Economic Analyst in the Rates Department of the Financial Analysis Division, presented his review of the rate case expense associated with the testimony of Ms. Valerie H. Grace, who testified regarding rate design for the Companies. Mr. Johnson reviewed the Companies' Schedule C-10, as well as the Companies' responses to Staff DRs, which included invoices for the rate case expense associated with Ms. Grace's testimony. He did not propose an adjustment to the rate case expense associated with Ms. Grace's testimony. (Staff Ex. 17.0, pp. 18-19)

Staff witness Mr. Michael Ostrander proposed adjustments to correct the amortization of the rate case expenses approved by the Commission in the Companies' 2011 rate cases. (Staff Ex. 13.0, p. 5) The Companies accepted Staff's adjustments in surrebuttal testimony. (NS-PGL Ex. 42.0, p. 4)

Staff recommends that the Order in this proceeding express a Commission conclusion as follows:

> The Commission has considered the costs expended by the Companies to compensate attorneys and technical experts to prepare and litigate these rate case proceedings and assesses that the amounts included as rate case expense in the revenue requirements of $2.286 million and $3.334 million for North Shore and Peoples Gas, respectively, are just and reasonable.

Support for Staff's recommendation can be found at Appendix C for North Shore and Appendix D for Peoples Gas.

D. Taxes Other Than Income Taxes and Invested Capital Taxes (Payroll) (Uncontested Except for Invested Capital Tax and Derivative Adjustments from Contested Adjustments)

1. Invested Capital Tax Computation and Derivative Adjustments

Staff witness Pearce proposed adjustments to update the calculation of invested capital tax to synchronize with the final revenue requirements that are ultimately approved by the Commission for North Shore Gas and Peoples Gas in this proceeding.

(Staff Ex. 4.0, pp. 21 – 23; Schs. 4.04 N and P) Staff's proposed methodology is consistent with the methodology approved by the Commission in the Utilities' previous rate cases, Docket Nos. 11-0280/11-0281 (Cons.) and Docket Nos. 07-0241/07-0242 (Cons.). The Companies accepted Staff's proposed methodology in the rebuttal testimony of witness Sharon Moy. (NS-PGL Ex. 26.0, p. 5)

Intervenor witnesses Mr. Brosch (AG Ex. 4.0, pp. 42 – 45; AG Ex. 4.1 and 4.2, Schs. C-11) and Mr. Smith (CUB-City Ex. 2.0, pp. 11 – 14) rejected this methodology and proposed adjustments to match the test year invested capital tax expense with the amounts paid or accrued in 2013, based on 2012 invested capital taxes and accruals. They contend the taxes calculated by the Utilities that are based on 2013 investment levels would not be payable or expensed on the books until after 2013. Therefore, they assert that the Utilities' approach actually yields an estimated tax expense for the following tax year, calendar 2014. Company witness Stabile responded to Mr. Brosch and Mr. Smith, asserting that the Utilities' estimated and accrued tax obligation should be based on 2013 invested capital beginning and ending balances as prescribed by law and not be estimated and accrued on 2012 beginning and ending balances. (NS-PGL Ex. 46.0, pp. 37 – 38)

Staff witness Pearce concluded that a future test year is based on forecasted amounts, and she believes a forecasted invested capital tax that is synchronized with the final revenue requirements that are ultimately approved by the Commission in this proceeding will more closely approximate this expense during the period these rates are in effect than will the actual amount paid during 2013 because that amount excludes the impact of additional investments made during the test year. (AG Cross Ex. 19, Request

AG-1.04 (e) to Staff) Staff's Appendices A and B, at page 10, reflect the proposed adjustments to ITC based on the Staff proposed revenue requirements.

E. Income Taxes (Including Interest Synchronization) (Derivative Adjustments from Contested Adjustments)

1. Appropriate Methodology to Reflect Change in State Income Tax Rate (see also Section V.C.6.a.)

Intervenor witnesses Smith (CUB-City Ex. 2.0) and Brosch (AG Ex. 4.0 – 4.2) proposed changes in the Companies' methodology to account for ADIT to reflect the scheduled decrease in the state income tax rate effective 2015 and a further decrease in 2025. Both witnesses assert that deferred tax expense should be reduced to reflect savings associated with this change.

Staff did not take issue with the Companies' position, noting that based on Staff's understanding of the order in Docket No. 83-0309, the methodology appears reasonable. (Staff Ex. 14.0, pp. 21 – 22)

F. Gross Revenue Conversion Factor

1. Methodology

2. Late Payment Charge Ratio

G. Net Operating Loss (Derivative Adjustment based on NOL Tax Asset)

See IV. C. 5. Net Operating Loss

VI. RATE OF RETURN

A. Overview

Three witnesses submitted testimony regarding the Companies' costs of capital. On behalf of North Shore and Peoples Gas, Mr. Paul R. Moul presented testimony regarding the Companies' cost of common equity (NS-PGL Exs. 3.0, 24.0 Rev., and 39.0) and Ms. Lisa J. Gast presented testimony regarding the Companies' proposed capital structures and overall weighted average costs of capital ("WACC"). (NS-PGL Exs. 2.0, 23.0, and 38.0) On behalf of the AG, Mr. Michael L. Brosch presented testimony regarding the Companies' cost of common equity, capital structures, and WACCs. (AG Exs. 1.0 and 4.0) On behalf of Staff, Mr. Michael McNally presented testimony regarding the Companies' cost of common equity, capital structures, and WACCs. (Staff Exs. 5.0 and 15.0) The following tables present Staff's proposals for the Companies' capital structures and component costs:

North Shore

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	$14,001,000	7.35%	1.80%	0.13%
Long-term Debt	$80,674,215	42.33%	4.64%	1.96%
Common Equity	$95,892,000	50.32%	9.06%	4.56%
Total Capital	$190,567,215	100.00%		
Weighted Average Cost of Capital				**6.65%**

Peoples Gas

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	$83,752,042	5.96%	1.26%	0.08%
Long-term Debt	$613,327,352	43.61%	4.47%	1.95%
Common Equity	$709,151,167	50.43%	9.06%	4.57%
Total Capital	$1,406,230,561	100.00%		
Weighted Average Cost of Capital				**6.60%**

In order to reduce the number of contested issues in the case, NS-PGL agreed to accept Staff's proposals regarding the appropriate capital structures, the embedded costs of long-term debt, and the costs of short-term for the Companies. (NS-PGL Ex. 38.0, p. 2) Thus, the only remaining contested issue between Staff and NS-PGL is the cost of common equity. Staff proposes to use a 9.06% cost of common equity, while the Companies propose using a 10.00% cost of common equity. (Staff Ex. 15.01; NS-PGL Ex. 38.1N; NS-PGL Ex. 38.1P) The AG proposes different capital structures and component costs than presented by either NS-PGL or Staff, resulting in a WACC of 6.83% for North Shore and a WACC of 6.79% for Peoples Gas. (AG Ex. 4.1, Sch. D; AG Ex. 4.2, Sch. D)

B. Capital Structure

Staff proposes using an average 2013 capital structure that contains 7.35% short-term debt, 42.33% long-term debt, and 50.32% common equity for North Shore and an average 2013 capital structure that contains 5.96% short-term debt, 43.61% long-term debt, and 50.43% common equity for Peoples Gas. (Staff Ex. 15.0, Sch. 15.01) NS-PGL has agreed to accept Staff's proposals regarding the appropriate capital structures for the Companies.

C. Cost of Short-Term Debt

Staff estimated that 1.80% is a reasonable estimate of North Shore's cost of short-term debt and that 1.26% is a reasonable estimate of Peoples Gas's cost of short-term debt. (Staff Ex. 15.0, Schs. 15.02N and 15.02P; NS-PGL Ex. 39.0, p. 2) NS-PGL has agreed to accept Staff's proposals regarding the costs of short-term debt for the Companies.

D. Cost of Long-Term Debt

The Companies and Staff agree that 4.64% is a reasonable estimate of North Shore's embedded cost of long-term debt and that 4.47% is a reasonable estimate of Peoples Gas's embedded cost of long-term debt. (Staff Ex. 15.0, Schs. 15.02N and 15.02P; NS-PGL Ex. 39.0, p. 2)

E. Cost of Common Equity

Three parties presented estimates of the Companies' costs of common equity: the Companies, the AG, and Staff. The Companies initially estimated North Shore's and Peoples Gas's return on equity ("ROE") to be 10.75%, but subsequently updated their estimate to 10.00%. (NS Ex. 3.0, p. 47; PGL Ex. 3.0, p. 47; NS-PGL Ex. 39.0, pp. 1-2) AG witness Brosch did not perform an analysis of the Companies' cost of common equity, but rather, proposes to use the same 9.45% cost of common equity authorized in the Companies' last rate setting proceeding. (AG Ex. 1.0, p. 61; AG Ex. 4.1, Sch. D; AG Ex. 4.2, Sch. D) Staff estimated North Shore's and Peoples Gas's ROE to be 9.06%. (Staff Ex. 5.0, Sch. 5.01)

Staff's Analysis

Staff witness Michael McNally estimated Peoples Gas's and North Shore's investor-required rate of return on common equity to be 9.06%. (Staff Ex. 5.0, Sch. 5.01) Mr. McNally measured the investor-required rate of return on common equity with discounted cash flow ("DCF") and Capital Asset Pricing Model ("CAPM") analyses. Mr. McNally applied those models to a sample of thirteen natural gas and electric delivery companies ("Delivery Group"). The Delivery Group was the same sample used by

Company witness Moul. (Staff Ex. 5.0, p. 13) To select that sample, Mr. Moul started with the universe of gas utilities categorized in Value Line's "Natural Gas Utility" group, which consists of eleven companies. He then eliminated two companies due to the different operations in which those companies engage. The nine remaining companies are: AGL Resources, Atmos Energy, Laclede Group, New Jersey Resources, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries, Southwest Gas, and WGL Holdings. To those nine he added four electric utility holding companies in Value Line's "Electric Utility (East)" industry group whose utility subsidiaries are engaged principally in the delivery of gas and electricity: Consolidated Edison, Northeast Utilities, PEPCO Holdings, and UIL Holdings. Together, those thirteen companies compose the Delivery Group. (NS Ex. 3.0, pp. 4-5; PGL Ex. 3.0, pp. 4-5)

DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in the Delivery Group pay dividends quarterly. Therefore, Mr. McNally applied a quarterly DCF model. (Staff Ex. 5.0, p. 14)

DCF methodology requires a growth rate that reflects the expectations of investors. Mr. McNally used a constant growth DCF model in which he measured the market-consensus expected growth rates with 3-5 year growth rate forecasts published by Zacks and Reuters. The growth rate estimates were combined with the closing stock prices and dividend data as of November 9, 2012. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimate of the cost of common equity was 9.32% for the Delivery Group. (Staff Ex. 5.0, pp. 16-18)

CAPM Analysis

According to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with the theory that investors are risk-averse and that, in equilibrium, two securities with equal quantities of risk have equal required rates of return. Mr. McNally used a one-factor risk premium model, the Capital Asset Pricing Model, to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. (Staff Ex. 5.0, pp. 18-19)

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Mr. McNally combined adjusted betas from Value Line, Zacks, and a regression analysis. The Delivery Group's average Value Line, Zacks, and regression beta estimates were 0.67, 0.58, and 0.54, respectively. The Value Line regression employs 259 weekly observations of stock return data regressed against the New York Stock Exchange ("NYSE") Composite Index. Both the regression beta and Zacks betas employ sixty monthly observations; however, while Zacks betas regress stock returns against the S&P 500 Index, the regression beta regresses stock returns against the NYSE Index. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Mr. McNally averaged the Zacks and regression results to avoid over-weighting monthly return betas. He then averaged that result with the Value Line beta, which produced a beta for the Delivery Group of 0.62. (Staff Ex. 5.0, pp. 24-29) For the risk-free rate parameter, Mr. McNally considered the 0.13% yield on four-week U.S. Treasury bills and the 2.77% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of November 9, 2012. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.3% and 4.9%. Thus, Mr. McNally concluded that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. (Staff Ex. 5.0, pp. 19-24) Finally, for the expected rate of return on the market parameter, Mr. McNally conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 12.81%. (Staff Ex. 5.0, p. 24) Inputting those three parameters into the CAPM, Mr. McNally calculated a cost of common equity estimate of 8.99% for the Delivery Group. (Staff Ex. 5.0, p. 29)

Recommendation

Based on a simple average of the mean sample estimates from his DCF and risk premium models, Mr. McNally estimated that the cost of common equity for the Delivery Group is 9.16%. To estimate the cost of common equity for the Companies, Mr. McNally adjusted the Delivery Group's investor-required rate of return downward 10 basis points to reflect the reduction in risk associated with Rider UEA, which was authorized in the Companies' last rate case with the same 10 basis point adjustment. Thus, Mr. McNally estimated the investor-required rate of return on common equity to be 9.06% for both North Shore and Peoples Gas. (Staff Ex. 5.0, p. 30)

Response to Criticisms of Staff's Analysis

Overall Results

The Companies devote a great deal of their testimony regarding Staff's ROE analysis to the proposition that Staff's results are "woefully inadequate." (NS-PGL Ex. 24.0 Rev., pp. 1-5) However, although Mr. Moul criticizes certain aspects of Mr. McNally's analysis, which Staff addresses below, he never demonstrates how the alleged errors he points to cause Mr. McNally to understate the ROE. In fact, Staff demonstrated that one of Mr. Moul's criticisms of Mr. McNally's analysis – that his use of a constant growth DCF model was chosen to produce a lower result – is factually incorrect, as Mr. McNally's use of a constant growth DCF actually produced a <u>higher</u> result than if a non-constant growth DCF had been used. (Staff Ex. 15.0, p. 12) Thus, the conclusion that Staff's results are too low cannot be drawn from the specific criticisms Mr. Moul alleges. The reality is, Staff's lower results are not due to any alleged errors by Staff, but are simply the results indicated by investor behavior, given the market environment. Indeed, Mr. Moul's results would have been similar to Staff's if he had not inappropriately adjusted his DCF and CAPM results and used an outdated, empirically unsupported, historical risk premium model. Both the adjustments he applied and his use of a risk premium model are theoretically unsound and, accordingly, have been repeatedly rejected in prior Commission proceedings. When those factors are removed, the average of the results of Mr. Moul's CAPM and DCF analyses for the Delivery Group and those of Mr. McNally's CAPM and DCF analyses differ by a mere 22 basis points, <u>with Mr. Moul's results being lower than Mr. McNally's</u>. (Staff Ex. 15.0, p. 8)

Mr. Moul argues that Staff's cost of common equity recommendation is "simply not representative of the returns investors can earn on other investments of comparable risk." (NS-PGL 24.0 Rev., p. 2) This criticism is unsubstantiated and clearly wrong. First, his argument is based on three inapt comparisons: (1) a comparison to previously authorized ROEs; (2) a comparison to his own upwardly adjusted ROE estimates; and (3) a comparison to Value Line forecasts of book value returns. The first approach has been fully discredited by Staff and rejected by the Commission in numerous prior rate setting proceedings. Mr. Moul's comparisons to previously awarded ROEs are meaningless, as not only do they represent authorized returns for *other* companies, in *other* jurisdictions, at *other* times during *other* market environments, but the facts needed to assess the degree of comparability, including such critical aspects as the relative risk of the utilities involved and the market environment in which those decisions were made, are entirely unknown. Without such data, those comparisons are useless. (Staff Ex. 15.0, pp. 8-9) Likewise, the second approach is uninformative because it depends on the proposition that Mr. Moul's upwardly adjusted estimates of the cost of common equity are accurate.[12] The third approach is also fatally flawed because it relies on forecasts of book earnings that are not only speculative, but are not comparable to the investor-required return. It is difficult enough to estimate the *current* investor-required return when actual data is available, but to attempt to project what investors will demand at some point in the *future* is pure speculation. Worse yet, the

[12] An estimate cannot be a useful benchmark of the accuracy of a different estimate until the accuracy of that "benchmark" estimate has been established. One could as easily argue that Mr. McNally's estimates of the cost of common equity demonstrate that Mr. Moul's estimates are too high, but Staff does not fall into this illogical dead end. Rather, as will be detailed later, Staff establishes the inaccuracy of Mr. Moul's cost of common equity estimates through an analysis of the tortured models and methodologies from which they were elicited.

Value Line projected returns on book equity that Mr. Moul cites are entirely unaffected by changes in the investor-required rate of return and, thus, cannot be used as a substitute benchmark for the investor-required return. In fact, investors cannot invest at (and earn a return on) book value, but must pay market value. Mr. Moul's own use of CAPM and DCF analyses to estimate the investor-require return recognizes as much, as those models are based on market value stock prices. Thus, those Value Line book value returns are clearly not returns investors can earn on other investments of comparable risk, rendering them invalid benchmarks for the investor-required return. (Staff Ex. 15.0, pp. 10-11)

Second, as Mr. McNally pointed out, given the context of the current interest rate environment, with interest rates at the lowest they have been in over 20 years and consistently trending lower, Mr. McNally's cost of common equity estimate <u>is</u> what a rational investor would expect. (Staff Ex. 15.0, p. 9) In response, Mr. Moul notes that the other component of the authorized return on equity, the equity risk premium,[13] has risen during that period, which he suggests means a higher authorized return is warranted. (NS-PGL Ex. 39.0, pp. 3-4) But Mr. Moul's testimony misleadingly divulges only part of the story; the rest of the story, which is revealed in his work paper, demonstrates his claim to be false. That work paper shows that the falling interest rates Mr. McNally cited more than offset the rising risk premium Mr. Moul cited. That is, contrary to Mr. Moul's implication, his own work paper explicitly shows that, along with the interest rates Mr. McNally cited, authorized returns have been steadily trending

[13] The market-required rate of return is composed of two components: the nominal risk-free interest rate and the equity risk premium. (Staff Ex. 5.0, p. 18)

downward for over 20 years and are at the lowest they have been in that time. (Staff Cross Ex. 8)

Spot data

Mr. Moul criticizes Mr. McNally's use of spot price data, arguing that it "invites all sorts of problems" in determining the investor-required return, suggesting that his use of historical average data somehow avoids those pitfalls. (NS-PGL 24.0 Rev., pp. 6-8) Mr. Moul's criticism of Mr. McNally's use of spot data is puzzling given that Mr. McNally's DCF estimate (9.32%), which used the most recently available stock prices, is <u>higher</u> than Mr. Moul's DCF estimate (8.49%[14]), which used stock prices averaged over a 6-month period. Regardless, while Staff's approach mitigates the problems Mr. Moul cites, Mr. Moul's use of historical average data increases the exposure to measurement error in his analysis due to its reliance on outdated data. Every day new information becomes available, and investors rethink their projections of future cash flows, the risk level of the company, and the price of risk in determining the market value of common stock. Thus, only the most recently available spot stock price will reflect all information that is available and relevant to the market, making it preferable to an outdated historical average. (Staff Ex. 15.0, p. 14) Further Mr. McNally employed a sample to minimize the effects of any potential "inefficiencies" in stock prices, as estimates for a sample as a whole are subject to less measurement error than individual company estimates. And although Mr. Moul claims that use of spot data can produce anomalous results due to potentially inefficient pricing, he did not provide any evidence that November 9th was in any way an anomalous day in the stock markets. In contrast, Mr.

[14] Before Mr. Moul applied his leverage adjustment. (Staff Ex. 5.0, p. 41)

McNally repeated his analysis every day for a week to determine whether or not his proposed cost of common equity reflects anomalous data. The results of those five analyses are all within five basis points of one another, demonstrating that Mr. McNally's November 9th result was clearly not an anomaly. Thus, those results do not warrant the abandonment of the traditional Commission practice of relying on spot data, from which the Commission has stated it is reluctant to deviate.[15] Moreover, during the period from which Mr. Moul selected his stock prices, investors saw prices change, ex-dividend dates pass, growth rates change, betas change, interest rates change, and overall market sentiment change – the country even held a Presidential election. While investors took all those things into account, Mr. Moul's use of outdated historical averages erroneously suggests that those events should not be reflected in the cost of common equity. (Staff Ex. 15.0, pp. 17-18)

DCF Analysis

Mr. Moul claims that Staff has been inconsistent with its DCF model selection, since Mr. McNally presented a non-constant growth DCF ("NCDCF") in the Companies' 2009 rate case, but presented a constant growth DCF in this proceeding, and accuses Mr. McNally of using a "lower of approach" to selecting a DCF model "to produce a lower DCF result." (NS-PGL Ex. 24.0 Rev., p. 9) Putting aside the aspersion, this criticism is both unfounded and patently false. Staff quite obviously did not use a "lower of approach" in selecting a DCF model in order to produce a lower DCF result, as Mr. McNally's use of a constant growth DCF in this proceeding produced a higher result

[15] The Commission specifically stated, "We note that the Commission has traditionally relied upon a single day's data in applying the DCF analysis, and we are very reluctant to deviate from Commission ratemaking practice." (Order, Docket Nos. 07-0241/07-0242 (Cons.), February 5, 2008, p. 92)

than if he had used the non-constant growth DCF methodology used in 2009. (Staff Ex. 15.0, p. 12) When confronted with this fact, Mr. Moul responded by arguing about the proper long-term growth rate to apply in an NCDCF. However, whether the proper NCDCF long-term growth rate is 3.35%, calculated consistent with Staff's 2009 methodology, or 4.33%, as calculated by Mr. Moul using a different methodology, both are <u>considerably lower</u> than the 4.83% sample average growth rate Mr. McNally actually used in his constant growth DCF analysis. Thus, Mr. McNally's use of a constant growth DCF in this proceeding would still produce a <u>higher</u> result than if he had used an NCDCF, which plainly disproves Mr. Moul's criticism. Moreover, Mr. McNally's use of a constant growth DCF model is consistent with the fact that Mr. Moul himself used a constant growth DCF in this proceeding. If Mr. Moul truly believed that Mr. McNally erred in not performing a non-constant growth DCF analysis, then Mr. Moul should have performed a non-constant growth DCF analysis himself.

Mr. Moul further claims to verify that Staff's DCF model "is not producing a reliable measure of the cost of equity" by comparing Mr. McNally's DCF result to that of the 28 utilities included in his S&P 500 market return estimate, which averaged 9.73%. (NS-PGL Ex. 24.0 Rev., p. 10) However, Mr. Moul has presented nothing to demonstrate that the growth rates used in the S&P utilities' estimates are sustainable. In fact, he explicitly acknowledges that the risk, and consequently the cost of common equity, for the S&P utilities would be higher than that of the Delivery Group, stating "the required common equity risk premium for the Delivery Group was 5.50%, which is less than that for the S&P Public Utilities due to differences in the composition of the companies that comprise each group." (NS-PGL Ex. 24.0 Rev., p. 13) Specifically, he calculates a 6.23% equity risk premium for the S&P Public Utilities. (NS Ex. 3.0, p. 35; PGL Ex. 3.0, p. 36) The 73 basis point difference between that and the 5.50% equity risk premium he calculated for the Delivery Group would suggest a DCF result of 9.00% (9.73% – 0.73% = 9.00%), which is lower than Mr. McNally's DCF result of 9.32%. Thus, Mr. Moul's own risk premium analysis contradicts his conclusion regarding Staff's DCF result.

CAPM Analysis

Mr. Moul criticizes Staff's CAPM analysis, stating that the regression betas Mr. McNally used have not been shown to "have any bearing on investor expected returns" and, instead, recommends the sole use of Value Line betas. (NS-PGL Ex. 24.0 Rev., p. 12) However, the validity of Staff's beta estimation methodology is not a function of whether investors rely upon Staff's beta estimates. Rather, the validity of the methodology is a function of its ability to explain stock price behavior. The methodology Mr. McNally used to calculate the regression beta for the Delivery Group, which Staff has regularly used and the Commission has consistently approved, (Order, Docket No. 02-0837, October 17, 2003, pp. 37-38; Order, Docket Nos. 02-0798/03-0008/03-0009 (Cons.), October 22, 2003, p. 85; Order, Docket No. 00-0340, February 15, 2001, p. 25; Order, Docket No. 03-0403, April 13, 2004, p. 42; and Order, Docket Nos. 06-0070/06-0071/06-0072 (Cons.), November 21, 2006, p. 145) employs the same monthly frequency of stock price data as the widely accepted Merrill Lynch methodology. (Staff Ex. 15.0, p. 20)

In addition, the betas Mr. Moul and Mr. McNally employed are merely estimates of the true beta, which is unobservable. Consequently, which beta estimates are more accurate is unknown. The Value Line methodology is not inherently superior to Staff's or Zacks's beta methodology. In fact, different beta estimation methodologies can produce different betas when those methodologies employ different samples of stock return data. Thus, just as both analysts used multiple models to determine the cost of equity, Mr. McNally used multiple approaches to estimate beta. In contrast, Mr. Moul proposes to exclude Staff-calculated and Zacks betas and rely upon only Value Line betas, a proposal which has been rejected multiple times by the Commission, including the Companies' 2009 rate case. In that proceeding, the Commission adopted Staff's multiple-source approach to estimating beta, stating:

> We agree that, in the same way we rely on multiple models to determine the cost equity, Staff's well-considered use of multiple beta sources is beneficial to reduce measurement error from any individual estimate. Moreover, we find that Staff's beta estimate appropriately weights the beta estimates from those three sources. Thus, we adopt Staff's beta estimate of 0.59.

(Order, Docket Nos. 09-0166/09-0167 (Cons.), January 21, 2010, pp. 126-127) The beta estimate Mr. McNally used in his CAPM analysis in this proceeding was calculated in the same manner as the beta adopted in that proceeding and, likewise, should be adopted once again.

Mr. Moul also asserts that Mr. McNally did not demonstrate that investors use Zacks betas as he adjusted them in the manner he proposes. (NS-PGL Ex. 24.0 Rev., p. 12) However, as explained above, the validity of Staff's beta estimation methodology is not a function of whether investors rely upon Staff's beta estimates. Further, the Commission has repeatedly rejected the use of unadjusted betas in favor of adjusted betas. Indeed, the Value Line betas Mr. Moul employed are adjusted betas.

Additionally, the specific adjustment Mr. McNally applied is appropriate. Mr. McNally used the same adjustment he applied to his regression beta, which, as noted above, has been repeatedly adopted by the Commission, since both use the same monthly frequency of stock price data as the widely accepted Merrill Lynch methodology. Moreover, the Commission ruled against similar arguments in Docket Nos. 94-0065 and 08-0363. (Order, Docket No. 94-0065, January 9, 1995, pp. 45, 47; Order, Docket No. 08-0363, March 25, 2009, pp. 68-69) In both cases, a party argued that it is preferable to use published betas that are likely to be used by investors. Thus, in Docket No. 08-0363, in response to such objections, Staff presented an alternative beta calculation using only published betas, some of which were unadjusted. In rejecting that approach, the Commission stated:

> The recommendation made by CUB and suggested by Staff that unadjusted betas should be used in the CAPM are rejected. The record does not support the proposition that unadjusted betas are superior to adjusted betas. To the contrary, the evidence shows that betas, including betas of utilities, do follow the revision to the mean proposition and that the use of unadjusted betas would tend to produce biased results. Additionally, the Commission does not find Nicor's objections to the adjusted regression betas contained in Staff's direct testimony to be persuasive. While that the DCF model requires the use of an observable input, market price, in the estimate of the cost of common equity, there is no such requirement for the beta input in the CAPM. Nicor identified no actual flaw in the calculations underlying Staff's adjusted regression betas and the Commission finds that they constitute a reasonable proxy for systematic risk in the CAPM.

(Order, Docket No. 08-0363, March 25, 2009, p. 69) Nevertheless, if the Commission agrees with Mr. Moul and decides that the Zacks beta should only be used as published (i.e., unadjusted), the beta for the Delivery Group would fall to 0.56, producing a CAPM ROE estimate of 8.39%. Alternatively, if the Commission decides the Zacks beta should just be eliminated, the beta for the Delivery Group would fall to 0.61, producing a CAPM ROE estimate of 8.89%. (Staff Ex. 5.0, pp. 26-28, and Sch. 5.08)

Downward Adjustment for Rider UEA

Mr. Moul argues that bad debt trackers for the companies in the Delivery Group render the Rider UEA adjustment that has been made in the Companies' last two rate cases unwarranted. (NS-PGL Ex. 24.0 Rev., pp. 17-18) However, Mr. Moul does not provide any data regarding the percentage of the revenues affected by bad debt trackers for the sample companies that have them. Many utilities have other operations or operate in multiple states that provide no bad debt recovery mechanisms. For example, while Mr. Moul lists Atmos Energy ("Atmos") among the sample companies that benefit from bad debt trackers, Atmos also has gas supply operations in Iowa, Missouri, Louisiana, Mississippi, and Georgia, which currently do not offer bad debt recovery mechanisms. In addition, Atmos has other business segments including pipeline and energy market services that would not benefit from bad debt trackers. Thus, we do not know the magnitude of the influence bad debt trackers have on the risk of the sample companies that have them, but clearly it is less for some of them than it is for the Companies. Moreover, by Mr. Moul's own findings, approximately 40% of the Delivery Group companies have no bad debt trackers at all. Therefore, it is clear that the Delivery Group companies do not enjoy the risk-reducing effects of bad debt recovery mechanisms to the extent that the Companies do and, thus, a downward adjustment to the Companies' authorized rate of return on common equity is still necessary. (Staff Ex. 15.0, p. 27)

Companies' Analysis

Company witness Moul estimated the Companies' cost of common equity using DCF, risk premium, and CAPM analyses, which he applied to a sample of thirteen natural gas and electric delivery utility companies. Based on his analysis, he initially recommended a 10.75% cost of equity for North Shore and Peoples Gas. (NS Ex. 3.0, pp. 3-4; PGL Ex. 3.0, pp. 3-4) In his surrebuttal testimony, Mr. Moul withdrew his proposal to reflect the results of his Combination Group or his size adjustment in his ROE commendation. Thus, he reduced his recommendation to 10.00%. (NS-PGL Ex. 39.0, pp. 1-2) Unfortunately, Mr. Moul's analysis still contains several errors that led him to over-estimate the Companies' cost of common equity. The most significant flaws in Mr. Moul's analysis of the Companies' cost of common equity are his: (1) inclusion of the results of an inappropriate risk premium model; (2) inclusion of an unwarranted leverage adjustment in his DCF and CAPM estimates; and (3) proposal for an upward adjustment for Rider VBA. (Staff Ex. 5.0, p. 32-35; Staff Ex. 15.0, p. 28)

Risk Premium Analysis Flaws

In determining the equity risk premium, Mr. Moul began with a 6.23% base equity risk premium estimate representing the historical earnings spread between investment grade public utility bonds and the S&P Utilities Index for the periods 1974-2007 and 1979-2007. Mr. Moul adjusted the 6.23% equity risk premium down to 5.50% in recognition of the lower risk of his proxy group in comparison to the S&P Public Utilities Index. He then added the 5.50% equity risk premium to a projected 5.50% long-term, A-rated public utility bond yield estimate, which resulted in a cost of common equity estimate of 11.00%. (NS Ex. 3.0, pp. 31-37; PGL Ex. 3.0, pp. 32-37)

Mr. Moul's risk premium analysis contains several flaws that undermine the reliability of the resulting estimates. First, Mr. Moul's base equity risk premium estimate is calculated from outdated data, which is inappropriate. Use of non-current data falsely assumes that market data reverts to a mean, despite the fact that security returns approximate a random walk. Moreover, no true mean exists. Therefore the selection of a measurement period will necessarily be arbitrary, and that arbitrarily selected measurement period will dictate the magnitude of a historical risk premium, as Mr. Moul's testimony demonstrates. For example, had Mr. Moul used the 1966-2007 measurement period, his base equity premium estimate would have been 4.85% rather than 6.23%, which would need to be adjusted downward even farther for the less risky Delivery Group. Thus, while this approach would, at best, only produce an accurate risk premium by sheer chance, it is unquestionably, and incurably, subject to manipulation. Second, Mr. Moul's measurement periods end in 2007, rendering his estimates extremely outdated, having been superseded by <u>5 years</u> of new data. Third, Mr. Moul added a risk premium measured from an investment grade bond index to an estimate of A-rated bond yield without providing any support that the two are comparable. Specifically, Mr. Moul provides no support that the public utility bond index has been, and remains, composed of A-rated bonds with similar terms to maturity as reflected in his A-rated bond yield estimate. Both term to maturity and credit rating are important determinants of bond returns. Fourth, Mr. Moul provided no quantitative support for the adjustments he made in deriving his estimate of the equity risk premium for the Delivery Group (5.50%) from the base equity risk premium (6.23%). (Staff Ex. 5.0, pp. 33-34)

Significantly, Mr. Moul presented the exact same approach in the Companies' 2009 rate case. The Commission rejected that analysis, noting "We have repeatedly rejected this model as a valid basis on which to set return on equity. Our view remains unchanged." (Order, Docket Nos. 09-0166/09-0167, January 21, 2010, p. 128)

Leverage Adjustment

Mr. Moul argues that in order to apply a measurement of a return measured based on a firm's market-value capitalization compared to a book-value capitalization, the measurement must be adjusted before it is applied to the firm's capitalization measured based on book value. (NS-PGL Ex. 24.0, p. 16) His argument is effectively an espousal of fair-value rate making. Fair value ratemaking entails estimating the fair, or market, value of a utility's property and then applying a market ROE to that value. (See., e.g., *Union Electric Co. v. Illinois Commerce Comm'n*, 77 Ill.2d 364, 374-375 (1979)) Section 9-210 of the Act put an end to fair-value ratemaking ("… For purposes of establishing the value of public utility property, when determining rates or charges, or for any other reason, the Commission may base its determination on the original cost of such property.") (220 ILCS 5/9-210) By Mr. Moul's reasoning, if an investor foolishly pays more for a utility stock than is warranted given his required return and the expected earnings, the Commission would then be required to increase the authorized return in order to ensure that the foolish investor still earns his investor-required return. (Staff Ex. 15.0, p. 22) That is the very essence of fair-value ratemaking – which Section 9-210 effectively put an end to almost 30 years ago.[16]

[16] Section 9-210 became effective January 1, 1986.

To illustrate, consider a company that includes two business segments of equal book value and equal risk – a regulated gas delivery company that is expected to earn exactly the investor-required return and an unregulated segment that is expected to earn more than the investor-required return. Investors (i.e., the market) would value the gas delivery segment equal to its book value because, at that price, investors would expect to earn exactly the return they require. However, investors would be willing to pay more than book value for the unregulated segment because of its higher-than-required earnings. Thus, the market value of the company as a whole would be bid up beyond its book value until the expected return equals the required return. Mr. Moul's argument suggests that the authorized return on rate base for the regulated gas delivery segment should be increased beyond the required return due to the excess expected earnings of the unregulated segment, which would, in turn, create excess earnings in the regulated gas delivery segment, pushing the market value higher still in a never-ending upward spiral. (Staff Ex. 15.0, p. 22)

Simply put, the only investment that is serving utility customers is the authorized book value rate base. Capital that is not invested in used and useful rate base serving utility customers should not earn a return from rate payers. By adjusting the ROE to account for market value investment above and beyond the book value, Mr. Moul's proposal would effectively nullify the Commission's decision to remove any non-utility assets from rate base.

Accordingly, the Commission has properly rejected the use of leverage adjustments in several prior proceedings. (Order, Docket Nos. 01-0528/01-0628/01-0629 (Cons.), March 28, 2002, pp. 12-13; Order, Docket Nos. 99-0120/99-0134 (Cons.), August 25, 1999, p. 54; Order, Docket No. 94-0065, January 9, 1995, pp. 92-93) In fact, Mr. Moul presented, and the Commission rejected, the exact same leverage adjustment, based on the same arguments, in the Companies' 2007 and 2009 rate cases. (Order, Docket Nos. 07-0241/07-0242 (Cons.), February 5, 2008, pp. 95-96; Order, Docket Nos. 09-0166/09-0167 (Cons.), January 21, 2010, pp. 128-129) The Order from the 2007 rate case quite clearly sets forth, in great detail, the reasons such a leverage adjustment should be rejected. For those reasons, that exact same leverage adjustment should be rejected once again in this proceeding.

Proposed Upward Adjustment for Rider VBA

In his rebuttal testimony, Mr. Moul suggested that a 10-basis point upward adjustment to the Companies' authorized ROE is warranted due to the possibility that Rider VBA may be rejected by the Appellate Court. (NS-PGL Ex. 24.0 Rev., pp. 18-19) Ironically, although this proposal was not introduced until his rebuttal testimony, it is premature on three counts. First, it assumes that Rider VBA, which apparently both the Commission and the Companies believe is valid, will be ruled invalid. Thus, his proposal would institute a very certain increase in rates based on a very uncertain legal outcome. Second, even if Rider VBA is eventually overturned, no one knows when that might occur. Thus, his proposal would produce higher rates beginning in July of this year, based on a ruling that may be not be made for quite some time after that. Third, his proposal assumes the Companies' request for straight fixed variable rates, should Rider VBA be overturned, will be rejected by the Commission. This proposal would largely mitigate the effects on the Companies' risk if Rider VBA is ultimately overturned.

Given that the Companies' request for straight fixed variable rates is still at issue in this proceeding, to assume it will be rejected is premature. (Staff Ex. 15.0, p. 28)

F. Weighted Average Cost of Capital

Staff's overall cost of capital recommendation, incorporating Mr. McNally's recommended capital structure and costs of short-term debt, long-term debt, preferred stock, and common equity, equals 6.65% for North Shore and 6.60% for Peoples Gas. (Staff Ex. 14.0, Sch. 14.1) The record consistently demonstrates that Mr. McNally's recommendations are based upon the valid application of sound financial theory, while those of Mr. Moul are not. Therefore, Staff recommends that the Commission adopt Mr. McNally's recommendations, as outlined below, to set rates in this proceeding.

North Shore

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	$14,001,000	7.35%	1.80%	0.13%
Long-term Debt	$80,674,215	42.33%	4.64%	1.96%
Common Equity	$95,892,000	50.32%	9.06%	4.56%
Total Capital	$190,567,215	100.00%		
Weighted Average Cost of Capital				**6.65%**

Peoples Gas

Capital Component	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	$83,752,042	5.96%	1.26%	0.08%
Long-term Debt	$613,327,352	43.61%	4.47%	1.95%
Common Equity	$709,151,167	50.43%	9.06%	4.57%
Total Capital	$1,406,230,561	100.00%		
Weighted Average Cost of Capital				**6.60%**

VII. WEATHER NORMALIZATION (Uncontested)

VIII. COST OF SERVICE

A. Overview

Both North Shore and Peoples Gas provided a cost of service ("COS") study with their filings in their respective Exhibits 13.1-13.8. The COS studies identify the revenues, costs, and profitability for each class of service and are the partial basis for the Companies' proposed rate design. Generally, the Companies prepared the COS studies utilizing three major steps: (1) cost functionalization; (2) cost classification; and (3) cost allocation of all the costs of the utility's system to customer classes. (Staff Ex. 7.0, p. 3) Staff witness Boggs testified that the COS studies appropriately assign costs to the various rate classes and are acceptable guidance tools for determining rates. He recommended that they be approved for use in this case. (*Id*., p. 2)

B. Embedded Cost of Service Study – Uncontested

IX. RATE DESIGN

A. Overview

The Companies are proposing continuation of Rider VBA (Variable Balancing Adjustment) with movement towards greater fixed cost recovery. (PGL Ex. 12.0 Rev., pp. 9-11 and NS Ex. 12.0 Rev., pp. 9-11) However, the Companies are also proposing that 100% Straight Fixed Variable ("SFV") rates for S.C. No. 1 Small Residential Heating ("HTG"), Non-Heating ("NH"), and S.C. No. 2 General Service classes be placed in the rate tariffs as a place holder in the event the Illinois Appellate Court overturns the Companies' Rider VBA. (PGL Ex. 1.0, p. 14; NS Ex. 1.0, p. 13)

Staff recommends the Commission: (1) approve Staff's proposal to recover 80% of non-storage related fixed costs through the customer charge for the S.C. No. 1 NH classes; (2) approve Staff's S.C. No. 1 HTG class rate design proposals that result in fixed cost recovery through fixed charges of approximately 68% for North Shore and approximately 61% for Peoples Gas and reject the Companies' proposal to recover 80% of non-storage related fixed costs through the customer charge for both Peoples Gas and North Shore S.C No. 1 HTG classes.; (3) reject the Companies' proposal to place 100% SFV ("Straight Fixed Variable") rates into the tariffs for the S.C. No. 1 and S.C. No. 2 classes as a place holder in the event the Illinois Appellate Court overturns the Companies' Rider VBA ("Volume Balancing Adjustment"); and (4) reject AG witness Rubin's proposed flat rate monthly customer charge and his proposed elimination of Rider SSC for the S.C. No. 1 NH classes.

B. General Rate Design

1. Allocation of Rate Increase

The Companies state that if the Commission approves a revenue requirement other than that proposed by the Companies, they will make the necessary adjustments to the appropriate Embedded Cost of Service Study ("ECOSS") accounts and allocators based on the findings in the Commission order in this proceeding. Assuming that the Commission approves the Companies' proposed rate design, the resulting allocation of the revenue requirement by rate and customer class from the ECOSS will then be used to set charges as discussed in the direct testimony of Companies witness Grace and by using the formulas reflected in the supporting rate design work papers. (Staff Ex. 8.0, p. 23)

Staff initially disagreed with the Companies' proposal for the setting of compliance rates, (*Id*.) but after further consideration agreed with the Companies' proposal. (NS-PGL Cross-Ex. 10, PGL-NS 13.01) The compliance rates would be derived by first adjusting the ECOSS accounts and allocators based upon the Commission's findings. Then, the rate design approved by the Commission per class would be used along with the Companies' proposed rate design compliance methodology described in NS-PGL Ex. 32.0, pp. 33-34.

2. Uniform Numbering of Service Classifications

Staff witness Alicia Allen, a Rate Analyst in the Department of the Financial Analysis Division on rate design and cost of-service issues, presented her review of North Shore's proposal for the uniform numbering of service classifications. Specifically, North Shore proposes to renumber S.C. Nos. 3, 4, and 6 as S.C. Nos. 4, 7, and 5 respectively, to be uniform with the service classifications of Peoples Gas. (NS Ex. 12.0, pp. 25-26) Ms. Allen recommends the Commission adopt North Shore's proposal. (Staff Ex. 9.0)

3. Bifurcation of S.C. No. 1 class

The Commission directed the Companies to present an embedded cost of service study to distinguish between low use and high use S.C. No. 1 customers in Docket No. 11-0280/11-0281 (Cons.). The Commission stated:

> Therefore, in their next rate case, we direct the Companies to present an ECOSS to distinguish between low use and high use S.C. No. 1 customers. Such proposals may include, without limitation, a rate design including a demand charge or a bifurcation of the S.C. 1 class into heating

> and non-heating classes or some other rate structure that better reflects customer class homogeneity to bring each group's bills more into line with their respective costs of service.

(Order, Docket Nos. 11-0280/11-0281 (Cons.), January 10, 2012, pp. 188-189)

The Companies are proposing, in the current case, to bifurcate the S.C. 1 Small Residential Service class into heating ("HTG") and non-heating ("NH") classes, as suggested by the Commission in Docket Nos. 11-0280/11-0281 (Cons.). (PGL Ex. 12.0 Rev., p. 12; NS Ex. 12.0 Rev., pp. 11-12)

Staff witness Johnson had no objection to the Companies' separation of the S.C. No. 1 Residential Service Class into HTG and NH classes for rate design purposes. (Staff Ex. 8.0, p. 21) Mr. Johnson stated that the Companies' proposal to have heating and non-heating classes for rate purposes is a logical step considering the Companies' historical record keeping for heating and non-heating customers on their systems. For rate making purposes, it makes sense to separate the HTG and NH customers because of the different demands they place on the system. Further, Mr. Johnson opined that the Commission was clear in its direction to the Companies in Docket Nos. 11-0280/11-0281 (Cons.) that they should present for the Commission's consideration a rate design that better reflects customer class homogeneity. The Companies' proposed rate design separates customers based upon historical data that reflects heating and non-heating cost of service demands. Separating the classes for cost of service purposes creates a greater homogeneity within each class. (*Id.*)

The AG addressed the bifurcation of the S.C. No. 1 rate class into heating and non-heating classes, but did not provide a recommendation for or against it in its expert witnesses' testimony. However, since the AG has proposed both heating and non-heating rates it appears that it does not object to the Companies' bifurcation proposal. (AG Ex. 3.0 R, pp. 10, 15, 20, 24) No other party provided written testimony addressing bifurcation of the S.C. No. 1 class.

4. Terms and Conditions of Service

Staff witness Allen presented her review of the Companies proposed language specific to the Application for Service section, that designates heating and non-heating classes as service classifications to restrict customers from switching service classifications more than once within a twelve-month period. (PGL Ex. 12.1, p. 9; NS Ex. 12.1, p. 7) Ms. Allen recommends adopting this language conditional on the Commission approving bifurcation of S.C. No. 1 into heating and non-heating customers. (Staff Ex. 9.0)

C. Service Classification Rate Design

1. Uncontested Issues

a. Service Classification No. 2, General Service (Straight Fixed Variable Rate Design Addressed in IX.C.2)

The Companies are proposing to maintain three meter classes for S.C. No. 2. They propose to move the total fixed cost recovery for the S.C. No. 2 class from approximately 56% to 64% for North Shore and from 37% to 45% for Peoples Gas. (Staff Ex. 8.0, pp. 32, 44) North Shore's proposed percentage of fixed cost recovery through the customer charges is 74% for meter class 1, 65% for meter class 2, and 54% for meter class 3. Peoples Gas's proposed percentage of fixed cost recovery through the customer charges is 62% for meter class 1, 55% for meter class 2, and 27% for meter class 3. (*Id*.) The Company is proposing to retain the three declining block distribution rate design, 1st 100 therms, next 2,900 therms, and over 3,000 therms for North Shore and 1st 100 therms, next 4,900 therms, and over 5,000 therms for Peoples Gas. (NS Ex. 12.4; PGL Ex. 12.4)

Staff witness Johnson did not object to the Companies' proposal to increase the customer charges by meter class to the proposed fixed cost percentages. Mr. Johnson stated that they reflect greater fixed cost recovery and will recover all customer related costs. Even with the proposed increase in fixed cost recovery, the total fixed cost recovery for S.C. 2 will be approximately 64% for North Shore and 45% for Peoples Gas. The Companies' proposed increase in fixed cost recovery for S.C. 2 is consistent with the Commission's recent move towards increased fixed cost recovery. Additionally, customers will continue to have the opportunity to adjust their bills in order to reduce costs since 33% of total costs for North Shore and 46% of total costs for Peoples Gas will continue to be recovered through the distribution charge. (Staff Ex. 8.0, pp. 33, 45)

Staff witness Johnson also did not object to the Companies' distribution charge proposals. Mr. Johnson stated that, generally, customer-related costs not recovered in the customer charge are recovered in the first block of the distribution charge. The Company has stated that all customer-related costs and a portion of non-storage related demand costs will be recovered through the customer charge. Mr. Johnson recommended the Company examine in its next rate case filing the feasibility of moving to two distribution blocks and also examine whether the current size therm blocks are still reasonable. (Staff Ex. 8.0, pp. 33-34, 45-46)

The Companies agreed with Staff's recommendation. (NS-PGL Ex. 32.0, pp. 30-31)

A bill comparison, utilizing the Companies' direct testimony revenue requirement, that identifies the impact of Staff's and the Companies' agreed upon S.C. No. 2 rate design proposals can be found on NS Ex. 12.10, pp. 3-5, PGL Ex. 12.10, pp. 3-5.

b. Large Volume Demand Service

The Companies are proposing to set the monthly customer charge at cost for the Large Volume Demand Service class. North Shore is proposing that the demand charge recover 67% of non-storage related demand costs and the distribution charge recover the remaining non-storage related demand costs. Peoples Gas is proposing that the demand charge recover 55% of non-storage related demand costs and the distribution charge recover the remaining non-storage related demand costs. (NS Ex. 12.0 Rev., pp. 21-22; PGL Ex. 12.0, p. 22)

Staff witness Johnson did not object to the Companies' rate design proposal for the Large Volume Demand class. Mr. Johnson opined that the Companies are proposing to set the customer charge at cost, which is a minimal part of a customer's total bill since these customers must use an average of over 41,000 therms per month. Additionally, the Large Volume Demand class proposal will recover its full cost of service. (Staff Ex. 8.0, pp. 34 and 46-47)

A bill comparison, utilizing the Companies' direct testimony revenue requirement, that identifies the impact of Staff's and the Companies' agreed upon Large General Service rate design can be found on NS Ex. 12.10, p. 6, PGL Ex. 12.10, p. 6.

c. Service Classification No. 8, Compressed Natural Gas Service

North Shore does not currently have a Compressed Natural Gas Service class. Peoples Gas is proposing to set the S.C. No. 8 Compressed Natural Gas Service class at cost and the distribution charge will recover the remaining revenues. (PGL Ex. 12.0 Rev., p. 22; PGL Ex. 12.4)

Staff has no objection to Peoples Gas' rate design proposal for the S.C. No. 8 rate class. Staff opined that the charges will recover the full cost to serve the customers and the S.C. No. 8 class is available to any customer for gas to be used as compressed natural gas to fuel a vehicle. Staff believes it is important that the S.C. No. 8 class rates reflect the full class cost of service so customers can make informed decisions concerning their use of natural gas in vehicles and their possible purchases of natural gas vehicles. (Staff Ex. 8.0, p. 47)

A bill comparison, utilizing the Companies' direct testimony revenue requirement, that identifies the impact of Staff's and the Companies' agreed upon Compressed Natural Gas Service rate design can be found on PGL Ex. 12.10, p. 8.

d. Contract Service for Electric Generation

Contract Service for Electric Generation is a contract service whereby the prices to be paid and the terms and conditions of service are mutually agreed upon. North Shore is not proposing any changes to the Contract Service for Electric Generation class. Peoples Gas is also not proposing any changes to the Contract Service for Electric Generation class. (NS Ex. 12.0 Rev., p. 22; PGL Ex. 12.0, p. 22)

Staff did not object to the Companies' proposals. (Staff Ex. 8.0, pp. 35, 48)

e. Contract Service to Prevent Bypass

North Shore stated that the sole negotiated contract for Contract Service to Prevent Bypass expires in 2012 and based upon discussions the Company has had with the customer, the Company anticipates that the customer is going to transfer to

Large Volume Demand Service in the test year. The Company has set the Contract Service to Prevent Bypass rates equal to the Large Volume Demand Service rates and has included the customer in the Large Volume Demand Service class for ECOSS purposes. (NS Ex. 12.0 Rev., pp. 8-9) Peoples Gas is not proposing any changes to the Contract Service to Prevent Bypass. (PGL Ex. 12.0 Rev., p. 22)

Staff witness Johnson did not object to the Companies' Contract Service to Prevent Bypass proposals. (Staff Ex. 8.0, pp. 35, 48)

f. Rider SSC, Storage Service Charge

The Companies are proposing a change in the per therm charge for the storage service charge resulting from the new revenue requirements proposed in this proceeding. (NS Ex. 12.0 Rev., p. 23; PGL Ex. 12.0 Rev., p. 23) Staff did not object to the Companies' proposals.

AG witness Rubin's direct testimony proposed that storage costs for the S.C. No. 1 non-heating class be recovered through the customer charge rather than through Rider Storage Service Charge ("SSC"). (AG Ex. 3.0 R, pp. 11, 16)

The Companies and Staff took issue with the AG's proposal and recommended that Rider SSC continue to be applicable to the S.C. No. 1 non-heating class. (NS-PGL Ex. 32.0, pp. 9-12; Staff Ex. 17.0, pp. 22-23)

In order to minimize the contested issues in this case, the AG accepted the Companies' proposal to exclude storage related costs from the AG's initial proposal. (AG Ex. 6.0, pp. 1-2)

2. Contested Issues – North Shore and Peoples Gas

a. Service Classification No. 1, Small Residential Non-Heating

The Commission should accept Staff's proposal to recover 80% of non-storage related fixed costs through the Companies' customer charge, which the Companies accepted in their rebuttal testimony. The Commission should also reject AG witness Rubin's proposal to implement a monthly flat rate with no distribution charge.

The Companies proposed in their direct testimony that fixed customer charges for North Shore recover 93% of fixed costs and 92% of fixed costs for Peoples Gas. (NS Ex. 12.0 Rev., p. 12; PGL Ex. 12.0 Rev., p. 12) A flat distribution charge per therm for sales and transportation customers was also proposed. The current distribution charge consists of two blocks, 0-50 therms and over 50 therms. (NS Ex. 12.4; PGL Ex. 12.4)

Staff witness Johnson was concerned that the Companies' proposed 93% fixed cost recovery for North Shore and 92% fixed cost recovery for Peoples Gas for the S.C. No. 1 NH customers would be excessive compared to the maximum fixed cost recovery amount of 80% approved by the Commission for Ameren and Nicor. (Docket Nos. 07-0585 and 08-0363) The current S.C. 1 combined HTG and NH class customer charge recovers 68% of fixed costs for North Shore and 57% for Peoples. (Staff Ex. 8.0, pp. 30, 42) North Shore's proposed S.C. 1 HTG fixed cost recovery is 75% and 68% for Peoples Gas. (NS Ex. 12.0 Rev, p. 13; PGL Ex. 12.0 Rev., p. 13) Mr. Johnson proposed recovery of 80% of non-storage related fixed costs through the customer charge and the remaining revenues collected through a declining two-block distribution rate structure in his direct testimony. Staff's proposed 80% fixed cost recovery was based upon the percentage approved by the Commission for Ameren and Nicor (Docket No. 07-0585 and Docket No. 08-0363, respectively). (Staff Ex. 8.0, pp. 31, 43) The

Commission has not approved fixed cost recovery above 80% at this juncture. Even under Staff's proposed 80% fixed cost recovery for the S.C. No. 1 non-heating class there is a dramatic decrease in the customer charge compared to the current combined S.C. No. 1 class. The decrease in the customer charge for non-heating customers, even at 80% fixed cost recovery, is a clear indication of the cost differences between heating and non-heating customers that was not apparent when the heating and non-heating customers were combined for COS purposes. Using the Companies' proposed direct testimony revenue requirement, the customer charge for the non-heating group would decrease from \$22.00 per month to \$14.48 for North Shore and from \$22.25 per month to \$13.63 for Peoples Gas. (NS-PGL Exs. 32.5, 32.6)

In rebuttal testimony, the Companies accepted Staff's proposal to recover 80% of non-storage related fixed costs through the customer charge. However, the Company disagreed with Staff's proposed two-declining block distribution charge and instead continued to recommend a flat distribution charge. (NS-PGL Ex. 32.0, pp. 7, 16)

Staff witness Johnson accepted the Companies' proposed flat distribution charge in rebuttal testimony. Mr. Johnson initially had concerns with bill impacts for customers using more than 250 therms per month but after further review noted that 95% of total bills for North Shore are for 50 therms or less and 96% of the total bills for Peoples Gas are 30 therms or less. For North Shore, 250 therms and above only represents 0.46% of total bills and for Peoples Gas it represents 0.13%. While some bills will fall into the higher usage categories, they are a small percentage of total bills and customers have the option of cutting back on usage to lower bills if they so desire. Additionally, moving to a flat block distribution charge will lower the amount per therm charged to low use customers (those customers using 50 therms or less). (Staff Ex. 17.0, pp. 5-6)

A bill comparison utilizing the Companies' direct and rebuttal revenue requirements that identifies the impact of Staff's and the Companies' agreed upon 80% fixed cost recovery rates and flat distribution charge (Column C), along with the AG's proposed S.C. No. 1 NH rates (Column I), can be found on NS-PGL Exs. 32.6, 32.7, 32.8, and 32.9.

AG witness Scott Rubin is proposing that both NS and PGL implement a monthly flat rate with no distribution charge for non-heating customers. (AG Ex. 3.0 R, pp. 10, 15) He is also proposing that storage costs be recovered through the customer charge rather than through Rider SSC. (*Id*., pp. 11, 16) Mr. Rubin states that the non-heating class is much more homogeneous compared to the heating class, with 85% of bills for PGL and 75% of bills for NS that are ten therms or less per month. (*Id.*, pp. 12-13) (Section 285.5130, Schedule E-8, Page 3 of 8 identifies 71% of bills for NS are for 10 therms or less not 75% as identified by Mr. Rubin) Also, Mr. Rubin indicated that the difference between typical winter and summer usage for the residential non-heating class is small. (*Id*., p. 12) Additionally, Mr. Rubin stated that with consumption varying by just a few therms from customer to customer and from month to month, in his opinion it is reasonable to simplify customers' bills and adopt a flat rate. (*Id*., pp. 12, 17)

Staff witness Johnson disagreed with AG witness Rubin's S.C. No. 1 NH rate design proposal. First, Mr. Johnson stated that even though 85% of bills for PGL and 71% of bills for NS are for ten therms or less that still leaves 15% for PGL (199,802 bills) and 29% NS (6,585 bills) that are above 10 therms. In fact, there are 2,633 bills for PGL usage above 200 therms, ranging from 200 therms to over 1,000 therms. Likewise, there are 142 bills for NS usage above 200 therms, ranging from 200 therms to approximately 900 therms. (Staff Ex. 17.0, p.21) So even though there are a high percentage of bills that are for 10 therms or less, there are still customers that use greater therms and place different demands on the system. Second, even though the difference between typical winter and summer usage for the residential non-heating class, as identified on AG Exhibit 3.01 and 3.04, is small, there is a distinct pattern of increased usage in the winter months. This indicates that the non-heating residential class is placing greater demands on the system in the winter compared to the summer months. So even though a large percentage of non-heating customers may be using 10 therms or less, there are some customers in the non-heating class that are using more therms and should be charged for the different demands they place on the system. (Staff Ex. 17.0, p. 21) Third, the Commission believes that leaving a portion of fixed costs to be recovered through the volumetric rate (20%) would encourage companies to see ways to improve efficiency and otherwise cut costs. (Order, Docket No. 07-0585 et al. (Cons.), September 24, 2008, p. 237; Order, Docket No. 08-0363, March 25, 2009, pp. 90-91) The Commission also has noted if all of their fixed costs were recovered through the monthly charge, companies may arguably over-recover their fixed costs through the monthly charge. (*Id.*)

With respect to AG witness Rubin's proposal for storage costs to be recovered through the customer charge rather than through Rider SSC, Mr. Johnson explained that because storage costs are demand related, they should be recovered on a per therm basis. Under Mr. Rubin's flat rate customer charge proposal, all non-heating customers would pay the same monthly flat rate, except for the cost of gas, regardless of the amount of therms they use and the demands they place on the system. It is not reasonable that customers with different demands pay the same charge for storage, even if there are not large differences in their demands. Therefore, Staff recommended that Rider SSC remain applicable to SC No. 1 NH customers. (Staff Ex. 17.0, pp. 22-23)

b. Service Classification No. 1, Small Residential Heating

The Commission should accept Staff's proposal to increase fixed cost recovery for North Shore to 68%, from its current 67%, and increase fixed cost recovery for Peoples Gas to 61%, from its current 54%, instead of the 80% the Companies propose for both North Shore and Peoples Gas.

North Shore initially proposed a customer charge for the S.C. No. 1 HTG class that would recover approximately 75% of fixed costs through fixed customer charges, along with a flat distribution charge that was set equal to the S.C. No. 1 NH class distribution charge. Peoples Gas initially proposed a customer charge for the S.C. No. 1 HTG class that would recover approximately 68% of fixed costs through fixed customer charges, along with a flat distribution charge that was set equal to the S.C. No. 1 NH class distribution charge. The Companies proposed identical distribution charges for S.C. No. 1 HTG and NH classes. The Companies stated that non-storage related costs for S.C. 1 HTG customers could either be recovered through a fixed monthly charge, or alternatively, through the distribution charge. The Companies proposed that the non-storage related costs be recovered through the distribution charge for the S.C. No. 1 HTG class so that they would match the S.C. No. 1 NH class distribution charge. The reason the Companies identified for having matching distribution charges for the heating and non-heating classes was to simplify the operation of Rider VBA, including any annual reconciliation calculations and adjustments. (NS Ex. 12.0 Rev., pp. 13-14; PGL Ex. 12.0 Rev., p. 14)

In the rebuttal stage of this proceeding the Companies changed their proposals and proposed to recover 80% of non-storage related fixed costs through the customer charge, along with a flat distribution charge for the S.C. No. 1 HTG class. (NS-PGL Ex. 32.0, pp. 23, 27-28) However, the Companies did not propose identical distribution charges for the heating and non-heating classes and did not address why it was suddenly not as important to have identical distribution charges for the heating and non-heating classes in the rebuttal stage.

Staff witness Johnson had no objection to the Companies' proposal to move to a flat distribution charge for the S.C. No. 1 HTG class. However, Mr. Johnson disagreed with the Companies' proposal to shift the non-storage related demand costs from the distribution charge to the customer charge for S.C. No. 1 HTG class. (Staff Ex. 8.0, pp. 25, 37) Mr. Johnson proposed recovering the non-storage related demand costs through the distribution charge. His proposal increases the fixed cost recovery for North Shore to 68%, from its current 67% fixed cost recovery, and increases the fixed cost recovery for Peoples Gas to 61%, from its current 54% fixed cost recovery. Mr. Johnson stated that Peoples Gas customers under present rates currently pay 25.963 cents per therm for the first 50 therms and 11.806 cents per therm for anything over 50 therms. Peoples Gas' shifting of the distribution charge costs to the customer charge shifts the price signal customers receive from the distribution charge. Approximately 48% of total bills are attributed to 50 therms or less which, currently, is charged at the

25.963 cents per therm. Decreasing the current distribution charge from 25.963 cents per therm to 10.054 cents per therm, as Peoples Gas' proposed in rebuttal testimony in order to recover 80% of fixed costs in the distribution charge, will not encourage customers to use less gas. (NS-PGL Ex. 32.3) Leaving the non-storage related demand costs in the distribution charge will ease the move to a flat rate while still encouraging conservation.

Additionally, the Company is proposing to bifurcate the S.C. No. 1 class and that split will affect the two customer groups differently. For example, the bifurcation produces the counter-intuitive result that the customer charge for the non-heating class decreases even though the percentage of fixed costs recovered through that customer charge increases under both Staff's and the Companies' proposals. This occurs because the bifurcation produces a reduction in the customer charge for the non-heating class that more than offsets the increase that would result from either Staff's or the Companies' fixed cost recovery proposals. This is not the case for the heating class. The Commission should observe what effects the S.C. 1 split has on all of its residential customers before moving forward on significantly greater fixed cost recovery through the customer charge. (Staff Ex. 8.0, pp. 25-26, 41)

Staff Ex. 8.0, Schedule 8.02N, Page 2, provides a bill comparison using North Shore's direct revenue requirement that compares North Shore's present and Staff proposed rates for the S.C. No. 1 HTG class. Staff Ex. 8.0, Schedule 8.02P, Page 2, provides a bill comparison using Peoples Gas's direct revenue requirement comparing Peoples Gas's present and Staff proposed rates for the S.C. No. 1 HTG class.

c. Service Classification Nos. 1 and 2, Alternative Conditional Straight Fixed Variable Rate Design

The Commission should reject the Companies' proposal to include a second set of rates for S.C. No. 1 and S.C. No. 2 customers as a contingent backup in the event Rider VBA is overturned in court.

The Companies propose 100% SFV rates for S.C. No. 1 Small Residential HTG, NH, and S.C. No. 2 General Service classes that would be placed in the rate tariffs as a place holder in the event Rider VBA is no longer in effect because of a third party's action. (PGL Ex. 1.0, p. 14; NS Ex. 1.0, p. 13) The Companies state that the SFV rate design would reflect a fixed monthly customer charge and no volumetric distribution charge. (PGL Ex. 12.0 Rev., pp. 17, 21; NS Ex. 12.0 Rev., pp. 16-17, 21) The Companies propose that if Rider VBA is not in effect then, at a minimum, if the Commission does not believe 100% SFV rates should be implemented, SFV rates recovering 80% of non-storage related fixed costs, along with a flat distribution charge should be implemented for S.C. No. 1 HTG, S.C. No. 1 NH, and S.C. No. 2. The Companies also propose that the 80% fixed cost recovery for S.C. No. 2 be applicable for each meter class. (NS-PGL Ex. 32.0, pp. 15, 20, 25, 29) Companies witness Grace argues that if the Illinois Appellate Court were to reverse the Commission's Order with regard to Rider VBA, customer charges recovering anything less than 100% of fixed costs would not result in the level of decoupling approved by the Commission in Docket No. 11-0280/11-0281 (Cons.). (PGL Ex. 12.0 Rev., p. 16; NS Ex. 12.0 Rev., p. 16)

Staff does not agree with the Companies that a 100% or 80% SFV rate should be added to the rate tariffs as a place holder in the event a third party's action, such as the Illinois Appellate Court, reverses the Commission's Order with respect to Rider VBA.

First, as demonstrated in Staff's direct testimony, Rider VBA and SFV rates are not equivalent substitutes for one another because they recover fixed costs in different proportions from different customers resulting in different rate impacts on customers. Rider VBA recovers any under or over recovery of fixed costs on a per therm basis. SFV rates would recover fixed costs on a per customer basis, which would affect small use customers greater than larger use customers. (Staff Ex. 8.0, pp. 10, 15)

Second, even if the Illinois Appellate Court reverses the Commission's Order in Docket Nos. 11-0280/11-0281 (Cons.) Staff is still proposing greater fixed cost recovery through fixed charges. If the Commission believes greater fixed cost recovery is warranted, then Staff's proposed non-SFV rates would meet that requirement in a way that is more consistent with prior Commission orders and that considers gradualism and conservation.

Third, if events occur that lead the Companies to believe that a different rate structure would be more appropriate, the Companies are able to file rate cases when they deem it necessary to do so. In fact, according to the Companies' own testimony, Peoples Gas and North Shore are currently required to file biennial rate proceedings in 2014 and 2016 under Section 9-220(h-1) of the Act. (Staff Ex. 8.0, p. 13)

Fourth, the Companies used customer demand forecasts for the 2013 test year which should minimize some of the Companies' concerns about adequate cost recovery. In fact, Companies witness Kevin R. Kuse testified that the Companies have used this same model in the past three rate cases and the model has performed well historically. (*Id.*, p. 17)

Fifth, having two rates in place will cause confusion for ratepayers or anyone else examining the tariff books. Tariffs are confusing enough for typical customers without presenting two sets of rates, one of which is not actually in effect. The Companies' proposal to present two different rates for the same service, one of which, the proposed SFV rate, takes two separate paragraphs to explain and has no effective date, would be very confusing to customers. It is in the best interest of the Commission and customers to have rate tariffs that are, to the greatest extent possible, easy to understand. In fact, the Act indicates that one of the goals and objectives of regulation is to ensure "the fair treatment of consumers and investors in order that…the application of rates is based upon public understandability and acceptance of the reasonableness of the rate structure and level." (220 ILCS 5/1-102(d)(ii)) Including two rates on a tariff sheet whereby one of the rates will become effective only if a court determines that the other rate is illegal is not only confusing but premature. In fact, there is no known effective date in the Companies' proposed tariff language. Even if Rider VBA is not allowed by the court to continue, there may be legal disputes over what the correct effective date of the new customer charges and distribution charges should be. (Staff Ex. 17.0, pp. 11-12)

Sixth, Rider VBA is still in effect and it is speculative as to whether it will be overturned.

Seventh, the Commission has already declined to approve 100% fixed cost recovery through a fixed charge. In fact, the Commission explained why it is important to leave a portion of fixed costs to be recovered through the volumetric rate:

> The Commission does not at this time approve recovery of all fixed costs in the monthly charges for two reasons. First, it is expected that leaving a portion of fixed costs to be recovered through the volumetric rate will encourage AIU to see ways to improve efficiency and otherwise cut costs. Second, as the number of AIU's customers grows, AIU should experience growing revenue. If all of its fixed costs were recovered through the monthly charge, AIU may arguably over-recover its fixed costs through the monthly charge.

(Order, Docket No. 07-0585 et al. (Cons.), September 24, 2008, p. 237)

The Commission was clear that it did not want 100% fixed cost recovery through a fixed charge

If the Commission decides to approve a SFV rate design as a back up in the event that Rider VBA is overturned, which it should not, the Commission should ensure that the fixed cost recovery does not exceed the 80% approved for Ameren and Nicor. The same reasons the Commission gave for not allowing Ameren and Nicor to have 100% fixed cost recovery also apply to Peoples Gas and North Shore. Additionally, the Commission should proceed gradually and cautiously in the movement towards greater fixed cost recovery to ensure that basic rate objectives are carefully taken into consideration. (Staff Ex. 8.0, p. 18)

Even if the Commission rejects Staff's arguments against the Companies conditional tariff proposal which it should not, the Companies' proposal should be rejected as a matter of law. The Companies' conditional tariff proposals are inconsistent with Section 9-201 of the Act. Section 9-201(a) provides in part that:

> Unless the Commission otherwise orders, and except as otherwise provided in this Section, no change shall be made by any public utility in any rate or other charge or classification, or in any rule, regulation, practice or contract relating to or affecting any rate or other charge, classification or service, or in any privilege or facility, except after 45 days' notice to the Commission and to the public as

> herein provided. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules or supplements stating plainly the change or changes to be made in the schedule or schedules then in force, *and the time when the change or changes will go into effect*, and by publication in a newspaper of general circulation or such other notice to persons affected by such change as may be prescribed by rule of the Commission. The Commission, for good cause shown, may allow changes without requiring the 45 days' notice herein provided for, by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(220 ILCS 5/9-201(a)) (Emphasis added) Under the Companies' proposal, the tariff only takes effect if it ever does at some unknown date in time depending on events outside the Commission's control. This proposed conditional tariff is contrary to the plain language of Section 9-201(a) that a tariff must state "plainly the change or changes to be made in the schedule or schedules then in force, and *the time when the change or changes will go into effect*" (220 ILCS 5/9-201(a))(Emphasis added) Since no one knows when the conditional tariff will take effect, if it ever does, the conditional tariff fails to comply with the requirement of Section 9-201(a) that an effective date be provided in the tariff. Accordingly, the conditional proposed tariffs of North Shore and Peoples Gas should be rejected as a matter of law.

D. Fixed Cost Recovery and Rider VBA

The Companies are proposing to collect a greater portion of fixed costs through fixed charges such as the customer charge and administrative charges. (PGL Ex. 12.0 Rev., p. 10; NS Ex. 12.0 Rev., p. 9) Staff witness Johnson identified past Commission Orders whereby the Commission addressed fixed cost recovery. Staff witness Johnson identified language that addressed fixed cost recovery from Orders in Docket Nos. 09-0166/09-0167 (Cons.) and 11-0280/11-0281 (Cons.) involving the Companies; Docket

No. 07-0588, 07-0589, and 07-0590 (Cons.) involving Ameren; and Docket No. 08-0363 involving Nicor. Staff observed that the Commission's Orders appear to be moving towards greater fixed cost recovery through fixed charges. However, Staff opined that the Commission should proceed gradually and cautiously in the movement towards greater fixed cost recovery. Staff witness Johnson explained that if too much emphasis is placed on ensuring revenue requirements are met through higher fixed charges, other basic rate objectives will be inadvertently overshadowed. (Staff Ex. 8.0, pp. 6-8) Staff noted that the Commission's Order in Ameren's Docket No. 07-0585 et al. (Cons.) made it clear that caution should be used recovering greater fixed costs in setting rates in order to meet certain rate objectives such as encouraging Ameren to improve efficiency and cut costs. Additionally, the Commission was concerned that Ameren could possibly over-recover its revenue requirement if too many fixed costs were recovered through the monthly charge. (*Id*., p. 11)

In rebuttal testimony, Companies witness Valerie Grace argued that "…if customer usage and sales vary from the normal level of sales used to set rates, lower customer charges and higher distribution charges will affect fixed cost recovery for the Utilities and appropriate billings to their customers." (NS-PGL Ex. 32.0, p. 36) Moreover, Ms. Grace argues that these factors can lead to over- as well as under-recovery of costs. (*Id*.)

In response, Staff pointed out that the utilities can over- or under-recover costs and this has been the case for years. Sales levels would be expected to fluctuate for any business venture. However, Staff does not believe the Commission's intent is to put rates in place for utilities so that a certain revenue requirement is guaranteed.

Section 1-102(a)(i) of the Act states: “tariff rates for sale of various public utility services are authorized such that they accurately reflect the cost of delivering those services and allow utilities to recover the total costs prudently and reasonably incurred.” (220 ILCS 5/1-102(a)(i)) Staff notes that in the Companies last rate case the Commission’s final order stated the following “[u]nder long established federal and Illinois constitutional law, and Illinois ratemaking law, a utility's rates must be set so as to allow it the opportunity to obtain full recovery of its prudent and reasonable costs of service, including its costs of capital. (Final Order, January 10, 2012, Docket Nos. 11-0280/0281 (Cons.), p. 5) (Emphasis added) Staff does not believe that acceptance of a smaller fixed cost recovery through fixed charges than requested by the Companies will all of a sudden adversely impact the Companies. The Companies have historically filed rate cases when they believed their rates were inadequate to cover their costs. Staff’s proposals still increase fixed cost recovery through fixed charges and the Companies will be in for a rate case again in 2014 as required under Section 9-220(h-1) of the Act. (Staff Ex. 17.0, p. 15)

X. Transportation Issues

A. Uncontested Issues

1. Purchase of Receivables (Withdrawn)

IGS witness Mr. Vincent Parisi in his direct testimony (IGS Ex. 1.0) made a proposal that Peoples Gas and North Shore be ordered by the Commission to begin a Purchase of Receivable (“POR”) program for Choices For You (“CFY”) suppliers. (Staff Ex 18.0, p. 2) Staff witness David Rearden responded to that IGS proposal among others made by Mr. Parisi in his rebuttal testimony. Mr. Rearden recommended that the

Commission not order Peoples Gas and North Shore to initiate such a POR program. (*Id*., p. 3) IGS withdrew its POR program proposal. (IGS Ex. 2.0, p. 6) Since IGS has withdrawn its POR program proposal for CFY suppliers the issue is moot.

2. Commission Authority to Order Investigation on Provider of Last Resort

See X., B., 4.

B. Contested Issues

1. Cost Allocation Between Sales Customers and Small Volume Transportation Customers

Staff witness Dr. Rearden addressed the recommendation by IGS witness Vincent Parisi that Peoples Gas and North Shore be directed by the Commission to revise their administrative charges to better reflect cost causation principles. (IGS Ex. 1.0, p. 44) Mr. Parisi made two recommendations. One, IGS was recommending that North Shore and Peoples Gas should stop charging CFY customers for costs that they allegedly do not cause, or in the alternative that CFY customers be given a credit for those costs. Two, that DFY administrative costs be recovered from both sales and transportation customers and not just CFY customers. (*Id*., pp. 5-6) Dr. Rearden testified that:

> [u]tility rate making is a complicated enterprise that involves allocating costs between many different competing groups. There are many examples of costs that the utility incurs that are paid for by all customers but might benefit one group more than another at a point in time. For example, construction in one part of town may have no effect on customers' services in another part of town. There is typically not enough data to disaggregate costs to specific types of customers.

(*Id*., p. 4) Dr. Rearden further noted that it is not always clear who the cost causer is. But in the case of the costs of CFY programs, those costs are tracked and are clearly caused by the transportation customers. With respect to the administrative services that Mr. Parisi alleges are mis-allocated to transportation customers, Dr. Rearden argued that those are costs that are not tracked like the CFY costs and it was less clear to him that sales customers are the sole cost causers. Given the above, Staff recommends that the Commission not make any changes as to how rates are calculated for these costs. (*Id*., p. 8)

2. Recovery of Supply-related Costs from Small Volume Transportation Program (Choices for You^{SM} or "CFY") Customers

See X., B., 1.

3. Recovery of Small Volume Transportation Program (Choices for You^{SM} or "CFY") Administrative Costs

See X., B., 1.

4. Provider of Last Resort Investigation

IGS witness Mr. Parisi recommended that the Commission order an investigation of whether North Shore and Peoples Gas should no longer be the provider of last resort ("PLR"). (Staff Ex. 18.0, p. 2) Staff's only comment on the IGS proposal was that if the Commission is interested in the topic at a theoretical level, it could order an investigation. (*Id*., p. 8) Staff witness Rearden did add that currently North Shore and Peoples Gas are not in a position to surrender their PLR responsibilities. (*Id*.)

XI. CONCLUSION

Staff respectfully requests that the Illinois Commerce Commission approve Staff's recommendations in this consolidated docket.

Respectfully submitted,

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